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ARTICLES

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INTRODUCTION

IN recent years, merger and acquisition activity has captured the corporate headlines, reaffirming the popular view that bigger is better. Yet the benefits of such empire building are belied by evidence that corporate spin-offs generally add more value to a business or group of businesses.[1] Indeed, the advantages of spin-offs have not been lost on some of the more astute corporate executives, and although mergers and acquisitions may make better copy, spin-offs have been quietly on the rise.[2] Companies such as AT&T, General Motors, ITT, Sprint, Dun and Bradstreet, and Sears have successfully reaped the benefits of performing tax-free spin-offs pursuant to Internal Revenue Code ("I.R.C." or "Code") § 355, the principle means of effecting them.[3] The largest benefit of a spin-off is that I.R.C. § 355 creates a tax-free shelter under which no gain or loss is recognized by either the distributing corporation or the shareholders receiving the distribution, thus eliminating the double taxation which otherwise would be incurred.[4] Section 355 and the applicable Treasury Regula-

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1. *See* F.H. Buckley, *The Divestiture Decision*, 16 J. Corp. L. 805, 807 (1991).

2. *See* Alex Mortals & Joann S. Lublin, *Rash of Corporate Breakup, Spinoffs Enriches Investors and Company Coffers*, Wall St. J., Sept. 21, 1995, at B1.

3. *See* Herbert S. Wander et al., *Recent Developments in Mergers and Acquisitions Activity with a Special Focus on Spin-offs*, *in* Advanced Securities Law Workshop 1997, at 311, 314 (PLI Corp. L. & Prac. Course Handbook Series No. B-1005, 1997).

4. *See* Louis S. Freeman et al., *Section 355: Tax Free Spinoffs, Split-offs, Split-*

tions ("Regulations"), however, establish several requirements that must be met before a spin-off will qualify as tax-free. These requirements demonstrate that the IRS disfavors spin-offs.

The main thrust of the requirements is to prevent spin-offs from being used as devices for extracting earnings and profits tax-free or at capital gain rates. For example, a primary hurdle to a tax-free spin-off is the business purpose test, a subjective test requiring that the spin-off be motivated by a real and substantial non-federal tax purpose germane to the business of the parent corporation, subsidiary, or affiliated group to which the corporation belongs.[5] The IRS uses the subjectivity of the business purpose test as a "filtering" mechanism to disqualify many corporations that would otherwise fulfill the requirements for a valid spin-off.[6]

There are numerous reasons why a corporation might want to pursue a spin-off, all of them "real" and "substantial" and having nothing to do with federal taxation. For example, many corporations have found that spin-offs unlock value in their businesses, thereby rewarding shareholders.[7] Other legitimate reasons for spin-offs include facilitating acquisitions, enhancing earnings from stock offerings, increasing management accountability, sharpening corporate fitness and focus, and increasing efficiency. In some circumstances, avoiding liability and providing takeover defenses may be appropriate justifications for spin-offs. In circumstances where these are not appropriate justifications, safeguards against entrenchment and state fraudulent conveyance laws have proven to be adequate deterrents to abuse.

All of the above legitimate, non-tax rationales ultimately serve to enhance shareholder value and are therefore consistent with directors' and officers' fiduciary duty to their shareholders—namely, to maxi-

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ups—Uses and Requirements, in Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financings, Reogranizations and Restructurings 1997, at 1017, 1019 (PLI Tax L. and Prac. Course Handbook Series No. J-408, 1997).

5. *See* Treas. Reg. § 1.355-2(b)(2) (as amended in 1992); *see also* Michael S. Paul, *Divisive Spin-offs Can Assist in Corporate Financing*, 22 Tax'n for Law. 351, 354 (1994) (discussing the business purpose test for spin-offs).

6. *See* Freeman et al., *supra* note 4, at 1099.

7. *See* Wander et al., *supra* note 3, at 314. Shortly after announcing or completing spin-offs, Dun and Bradstreet and AT&T, among others, experienced surges in their stock-prices. In January 1996, Dun and Bradstreet announced a three-way break-up in which it would spin off two smaller companies. *See* Steven Lipin, *Cognizant, A D&B Spinoff, to Split in Two*, Wall St. J., Jan. 15, 1998, at A3. Shareholders holding Dun and Bradstreet stock shortly before the break-up enjoyed a roughly 40% gain by the end of 1997. *See id.* AT&T also experienced benefits in April 1996 in a spin-off in which AT&T shareholders received shares of a newly independent company called Lucent Technologies. The value of Lucent stock has since tripled. *See* Jim Lawless, *How Spinoffs Can Help your Portfolio*, Chi. Sun-Times, Feb. 17, 1998, at 46. This increase is because the divestiture served to remove conflicts of interest between the two companies that had constrained growth. *See* Joe Cornell, *Mailbag: Spinoffs' New Role*, Barron's, Apr. 20, 1998, at 61. Since the spin-off, the ability of the former AT&T division to sell equipment has been enhanced. *See id.* at 62.

mize value. The current tax law, however, ignores this duty and often frustrates it. This Article proposes that I.R.C. § 355 and the accompanying regulations should be revised to facilitate rather than hinder corporate spin-offs. Part I reviews the history of the tax treatment of spin-offs and outlines the section 355 provisions, treasury regulations, and revenue rulings that currently govern spin-offs. Part II considers some improper motives for spin-offs, but argues that legal safeguards against entrenchment and state fraudulent conveyance laws adequately address abusive spin-offs. Part III examines the legitimate, non-tax rationales behind spin-offs within the context of management's fiduciary duty to maximize shareholder value. Finally, Part IV analyzes the reasons why the tax law should encourage spin-offs and suggests revisions to section 355 to facilitate them.

I. TAX TREATMENT OF SPIN-OFFS UNDER I.R.C. § 355

A spin-off is one type of tax-free corporate division permitted under section 355 of the Code.[8] A spin-off involves the distribution in the form of a dividend by a parent corporation to its shareholders of the stock of a subsidiary in which the parent possesses a controlling interest.[9] The new entity's shares are distributed on a pro-rata basis to existing shareholders of the parent company, without a requirement that the shareholders surrender any stock of the parent in return.[10] After the distribution is complete, the shareholders of the parent company become the owners of two separate and independent companies,[11] and own the same proportion of stock in the subsidiary as in the parent corporation. For many corporations, the benefits of such a divestiture are immediately apparent.[12]

8. *See* I.R.C. § 355 (1999).

9. *See* Steven C. Thompson & Stephen J. White, *Business Purpose Is the Key to Tax-Free Spin-Offs*, 52 Tax'n For Acct. 98, 98 (1994).

10. *See* Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 Va. L. Rev. 1, 49 n.135 (1986).

11. *See* Kevin M. Warsh, *Corporate Spinoffs and Mass Tort Liability*, 1995 Colum. Bus. L. Rev. 675, 677 n.6.

12. A split-off and a split-up are two other types of tax-free corporate divisions permitted by section 355. A split-off involves the surrender of part of a shareholder's stock in the parent corporation in exchange for stock in the subsidiary. *See* James M. Lynch, *Tax Free Spin-offs Under Section 355*, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 1997, at 875, 887 (PLI Tax L. and Est. Plan. Course Handbook Series No. J4-3690, 1997). A split-off is analogous to a partial redemption of a shareholder's interest. In a split-up, on the other hand, the parent corporation dissolves after distributing stock to its shareholders in two or more controlled corporations. *See* Lynch, *supra*, at 887-88. Even though each of the above forms may qualify for tax-free treatment under section 355, the tax consequences with respect to boot and other matters may differ depending on the form employed.

A. *A Brief History of the Tax Treatment of Spin-Offs*

Section 203(c) of the Revenue Act of 1924 provided that if there was a distribution of stock or securities to a shareholder pursuant to a plan of reorganization without the surrender of stock or securities by the shareholder, no gain would be recognized by the shareholder from the receipt of such stock.[13] This provision granted a blanket exemption that served as a device to avoid the tax on dividend income, an exemption that remained available until the landmark case of *Gregory v. Helvering*[14] promulgated the business purpose test. In *Gregory*, the taxpayer attempted to extract assets from a corporation at capital gain rates by transferring the assets (stock in another corporation) to a newly organized subsidiary, which was dissolved immediately thereafter and the assets distributed to the taxpayer.[15] In ruling against the taxpayer, the Supreme Court stated that although the transaction was in full compliance with the letter of the spin-off statute, it was devoid of any business purpose and was thus indistinguishable from an ordinary dividend.[16]

Even before the *Gregory* case reached the Supreme Court, Congress enacted the Revenue Act of 1934, which treated spin-offs as ordinary distributions to be taxed as dividends.[17] After several proposals to reinstate the spin-off as a vehicle for a tax-free reorganization, Congress finally amended the Code in 1951 to provide for a tax-free spin-off under section 112(b)(11)[18] but incorporated the device test into the provision to deter tax avoidance practices.[19] Section 112(b)(11) was finally replaced in 1954 by the far more elaborate provisions of section 355, which now appear as amended in 1986.[20]

In 1986, the IRS again revised the Code and repealed the *General Utilities* doctrine[21] that had been codified under section 311(a)(2) of the 1954 Act. The *General Utilities* doctrine provided that a corporation generally did not recognize a gain or loss on the distribution of appreciated property to its shareholders.[22] Congress repealed this

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13. *See* I.R.C. § 203(c) (1924).

14. 293 U.S. 465 (1935). In *Gregory*, the taxpayer actually relied on section 112 of the Revenue Act of 1928, *see id.* at 468, which was identical to section 203(c) of the Revenue Act of 1924.

15. *See Gregory*, 293 U.S. at 467.

16. *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 11.01[2][a] (6th ed. 1994).

17. *See id.*

18. I.R.C. § 112(b)(11) (1954).

19. *See id.* A spin-off was presumed to be tax free under section 112(b)(11) unless it appeared that a corporation that was a party to a reorganization "was not intended to continue the active conduct of a trade or business after such reorganization or ... the corporation whose stock [was] distributed was used principally as a *device* for the distribution of earnings and profits to shareholders." *Id.* (emphasis added).

20. *See* I.R.C. § 355 (1986).

21. *See* General Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935).

22. *See* John R. Wilson, *A New Spin on Corporate Spin-offs: Rev. Proc. 96-30,*

doctrine by enacting section 311(b), which requires a distributing corporation to recognize a gain whenever the fair market value of the property distributed exceeds its adjusted basis. Congress repealed the *General Utilities* doctrine because it granted "a permanent exemption from the corporate income tax" by permitting assets to take a stepped-up basis in the hands of shareholders without the imposition of a corporate-level tax.[23] After the repeal of the *General Utilities* doctrine, section 355 became "the most significant remaining statutory exception"[24] to the rule that all corporate distributions of appreciated property are subject to double taxation. Consequently, section 355 has been the principal means of effecting spin-offs.[25]

In the absence of section 355, if the fair market value of a controlled corporation's stock were to exceed the adjusted basis in the hands of the distributing corporation, section 311(b) would mandate that the distributing corporation recognize a gain equivalent to the appreciation of the distributed stock.[26] In addition, the shareholders of the distributing corporation would have to include in their gross income the fair market value of the stock,[27] which would be taxable as a dividend to the extent of corporate earnings and profits.[28] Fortunately, section 355(a) provides shelter from immediate double taxation. The section stipulates that no gain or loss shall be recognized by the shareholder of a distributing corporation who receives stock of a controlled corporation, provided that the transaction meets certain conditions. As a qualifying transaction, the tax on the above distribution would be completely deferred until the shareholders of the distributing corporation sold the stock they had received. Upon receipt of the stock, the shareholders take a carryover basis under section 358(a), and they would be subject to only one level of tax, at capital gain rates, upon disposition.

B. *Current Tax Treatment of Spin-Offs*

A qualifying spin-off under section 355(a) produces two separate corporations that are each owned by the shareholders of the distributing corporation without the recognition of a gain.[29] Nonetheless,

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Colo. Law., Oct. 1996, at 109, 111 n.1 (1996).

23. Bittker & Eustice, *supra* note 16, at ¶ 8.20[4].

24. *See* Freeman et al., *supra* note 4, at 1096.

25. *See* Wilson, *supra* note 22, at 109.

26. I.R.C. § 311(b) states that where a corporation distributes appreciated property to a shareholder, "gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value." I.R.C. § 311(b) (1999). Hence, the distributing corporation will have taxable income equal to the difference between the fair market value and the adjusted basis of the property distributed. *See id.* § 311(b)(1)(B).

27. *See id.* § 61(a)(7).

28. *See id.* §§ 301, 316 & 317(a).

29. *See id.* § 355(a).

due to the potential for tax avoidance associated with spin-offs, section 355 sets forth several conditions that need to be met for a spin-off to qualify for tax-free treatment. Part I.B.1 addresses the requirement most scrutinized by the IRS: the independent business purpose test.[30]

1. The Independent Business Purpose Test

Section 355 requires an "independent business purpose" for the spin-off to receive tax-free treatment.[31] The business purpose test is a subjective test governed by Treasury Regulation § 1.355-2(b)(2), which requires that a spin-off be motivated by a real and substantial nonfederal tax purpose germane to the business of the entities involved.[32] The IRS "has made business purpose the primary hurdle in obtaining a ruling on a section 355 transaction."[33] Moreover, the regulations generally disfavor spin-offs, deeming corporate divisions the final step in solving business problems.[34] Thus, if there is an alternative available for achieving the alleged business purpose without the distribution of stock of a controlled corporation, and the alternative is neither impractical nor unduly expensive, then the spin-off will fail the business purpose test.[35]

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30. The second requirement under section 355 is that the distributing corporation must be in "control" of the controlled corporation immediately before the distribution. *See id.* § 355(a)(1)(A). The third requirement for a tax-free spin-off mandates that, immediately after the distribution, both the distributing and controlled corporation must be engaged in the "active conduct of a trade or business." *Id.* § 355(b). The fourth requirement under section 355 inquires into whether there is continuity of interest. *See* Treas. Reg. § 1.355-2(c)(1) (as amended in 1992). The continuity-of-interest principle is a fundamental concept with respect to the nonrecognition provisions under the Code. *See* Bittker & Eustice, *supra* note 16, at ¶ 12.01[1]. Consequently, for a spin-off to qualify for tax-free treatment, the shareholders of the parent corporation as a group must own and not have a plan or intent to dispose of shares of the parent or subsidiary following the distribution of stock. *See* Paul, *supra* note 5, at 355-56. The fifth requirement under section 355 is that the spin-off must satisfy the device test, a subjective test that examines whether the spin-off is being used principally for extracting corporate earnings and profits at capital gain rates. *See* I.R.C. § 355(a)(1)(B) (1999); *see also* Paul, *supra* note 5, at 352-53 (reciting that under section 355 (a)(1)(B) the transaction cannot be intended as a "device" for distribution of earnings and profits). The final requirement for a tax-free spin-off concerns the amount of control the distributing corporation's shareholders possess immediately after a distribution. For a distribution to be tax-free, the distributing corporation must distribute all of the stock of the subsidiary or a sufficient amount to constitute control. *See* I.R.C. § 355(a)(1)(D) (1999). Control in this case requires ownership in vote and value of at least 50% of the subsidiary's stock immediately after distribution. *See* § 368(c).

31. *See* Thompson & White, *supra* note 9, at 99.

32. *See* Treas. Reg. § 1.355-2(b)(2) (as amended in 1992); *see also* Paul, *supra*, note 5, at 354 (discussing the requirements of Treas. Reg. § 1.355-2(b)(2)).

33. *See* Freeman et al., *supra* note 4, at 1096. The Service uses the business purpose test as a "filtering" mechanism to limit the use of tax-free spin-offs, approving less than would otherwise qualify. *See id.* at 1099.

34. *See* Thompson & White, *supra* note 9, at 104.

35. *See id.* at 100; Treas. Reg. § 1.355-2(b)(3) (as amended in 1992).

Despite the seemingly stringent requirements of the business purpose test, however, the IRS has approved a long list of business purposes.[36] For example, preventing hostile takeovers by eliminating undervaluation of the company in the market,[37] or enhancing access to debt financing or equity capital have been held to constitute valid business purposes.[38] Conversely, the IRS has ruled that neither maximizing shareholder value[39] nor enabling the parent corporation or subsidiary to qualify for an S Corporation election[40] satisfies the business purpose test.

2. Restrictions of IRC § 355

The Taxpayer Relief Act of 1997 amended section 355 by adding subsection (e), which provides that the acquisition by one or more persons directly or indirectly of at least 50% in vote or value of either the distributing or any controlled corporation stock pursuant to a plan or series of transactions will result in the recognition of a gain.[41] Although there are several exceptions to section 355(e),[42] only two are relevant for the purposes of this Article.

The first exception provides that if the shareholders of the distributing corporation continue to own, directly or indirectly, more than

36. *See* Rev. Rul. 96-30, 1996-1 C.B. 696 (providing a long, but non-exhaustive, list of valid business purposes).

37. *See* Freeman et al., *supra* note 4, at 1165 (citing Priv. Ltr. Rul. 88-19-075 where taxpayer received a favorable ruling after a person with a history of hostile takeovers filed a securities filing and the taxpayer's investment banker warned that the corporation was vulnerable to takeover at an inadequate price).

38. *See* Thompson & White, *supra* note 9, at 101; *see also* Rev. Rul. 85-122, 1985-2 C.B. 119 (separating golf and tennis resort in one state from unprofitable ski resort in another prior to issuing bonds ruled to satisfy business purpose test); Rev. Rul. 82-130, 1982-2 C.B. 83 (discussing the Service's ruling that separation of high-tech business from debt-laden real estate business prior to stock offering constituted a business purpose). Other valid business purposes include settlement of shareholder disputes, state tax savings, compensation of key employees, separation of regulated and non-regulated businesses, enhancing customer relations, separating union and non-union businesses, complying with divestiture orders of courts or government bodies, reducing foreign income taxes, and facilitating acquisitions. *See* Thompson & White, *supra* note 9, at 101.

39. *See* Thompson & White, *supra* note 9, at 99; *see also* Rafferty v. Commissioner, 452 F.2d 767, 770 (1st Cir. 1972) (holding that shareholder purpose is insufficient to satisfy the business purpose test).

40. *See* Thompson & White, *supra* note 9, at 101.

41. I.R.C. § 355(e) (1997). The distribution will, however, remain tax free to the shareholders of the distributing corporations. *See* Roger Ritt, *The Taxpayer Relief Act of 1997: Selected Corporate Tax Changes*, 65 ALI-ABA 565, Mar. 12, 1998, at 572. Congress's decision to enact subsection (e) may have been spurred by the expanded and abusive uses of *Morris Trust* techniques to effect some highly-publicized transactions which more closely resembled sales but were never subject to the corporate-level tax. *See* Diana M. Lopo, *How the New Tax Law Affects Acquisitions, Spin-offs and Other Corporate Transactions*, M & A Law., Nov.-Dec. 1997, at 22, 24.

42. *See* Mark J. Silverman et al., *Spin-Offs: The New Anti-Morris Trust and Intragroup Spin Provisions*, Tax Notes, Jan. 19, 1998, at 329, 339.

50% in vote and value of all the corporate parties to the spin-off, section 355(e) will not apply.[43] Even if there is an acquisition of the distributing or controlled corporation pursuant to a plan after a spin-off, as long as there is continuing control by the distributing corporation's shareholders, no gain will be recognized.[44] The second exception does not permit gain recognition if, after the change of ownership, the distributing and all the controlled corporations remain part of the same affiliated group.[45] For the purposes of section 355(e), the phrase "affiliated group" includes a broader range of entities than those regularly allowed under section 1504(b).[46] In addition, intragroup spin-offs involving the distribution of stock from one member of an affiliated group to another are excluded from the purview of section 355(e).[47]

According to some commentators, section 355(e) was designed to eliminate so-called *Morris Trust* transactions.[48] *Morris Trust* transactions, first named in the landmark Fourth Circuit case *Commissioner v. Morris Trust*,[49] generally involve the disposition of unwanted businesses pursuant to a spin-off in preparation for a tax-free acquisition by another corporation.[50] The legislative history of section 355(e) shows that the term "acquire" is not limited to purchase transactions, but also includes tax-free carryover basis acquisitions.[51] As a result, under the current statutory scheme, a parent corporation that merges into another corporation after spinning off an unwanted subsidiary will be deemed to have new owners, and will incur a tax liability equal to the entire appreciation of the subsidiary stock.[52] The recognition of

43. *See* I.R.C. § 355(e)(3)(A)(iv) (1999).
44. *See* Silverman, *supra* note 42, at 338.
45. *See* I.R.C. § 355(e)(2)(C).
46. *See* Silverman, *supra* note 42, at 339 n.87.
47. *See* I.R.C. § 355(f).
48. *See, e.g.*, Silverman, *supra* note 42, at 334 (stating that the legislative history of section 355(e) calls attention to several "abuses," which the Act was designed to curb).
49. 367 F.2d 794 (4th Cir. 1966). In *Morris Trust*, American Commercial Bank, a state bank, negotiated a merger agreement with Security National Bank of Greensboro, a national bank. *See id.* at 795. Because banking laws prohibited national banks from operating an insurance department, American Commercial Bank first organized a subsidiary, transferred its insurance business assets to it and distributed the subsidiary's stock to its shareholders prior to its merger with Security National Bank. *See id.* The Fourth Circuit affirmed the Tax Court's ruling that the taxpayer had no recognizable gain arising from the aforesaid transactions. *See id.* at 802. The Service subsequently made known its decision to follow the Fourth Circuit's decision in *Morris Trust* through Rev. Rul. 68-603. *See* Stephen E. Wells, *Restructuring in Connection with Tax-Free Spin-Off Transactions*, *in* Tax Law and Practice 1997, at 175, 206 (PLI Tax L. & Est. Plan. Course Handbook Series No. J4-3690, 1997).
50. *See* Silverman, *supra* note 42, at 329.
51. *See id.* at 337.
52. *See* George K. Yin, *Morris Trust, Sec. 355(e), and the Future Taxation of Corporate Acquisitions*, Tax Notes, July 20, 1998, at 375, 375-76. The new shareholders of the parent corporation are the shareholders of the corporation into which the parent is merged. *See id.* at 375.

a gain in the above transaction must be based on a finding by the IRS that the distribution was part of a "plan" for the acquisition.[53] Such a finding is not uncommon, however, since there is a rebuttable presumption under the statute that "any acquisition occurring two years before or after a section 355 distribution is part of a plan."[54]

The wording of section 355(e) is troubling for several reasons. Primarily, the Code fails to define what it means by a "plan" or "series of related transactions."[55] In addition, it is unclear how the existence of a "plan" is determined, or what kind of evidence would be sufficient to rebut the four-year presumption of the existence of a plan.[56] Finally, it is not clear whose plan is relevant.[57] Without clearly defined guidelines, the existence of a "plan" must be determined based on the facts and circumstances surrounding each transaction.[58] Nevertheless, the lack of any explanation of the term "plan" in the Code or legislative history has created some dispute as to whether a "plan" can be unilateral or whether it is limited "to cases in which there is, at a minimum, negotiations, agreements, or other arrangements as a result of which an ensuing transaction takes place."[59] There is some precedent, although in a different context, indicating that a unilateral plan preconceived by a historic shareholder to dispose of stock would still constitute a plan and destroy the continuity-of-interest requirement, even though the plan was devoid of any negotiations or agreements.[60]

Furthermore, because the legislative history of section 355(e) does not specifically exclude hostile takeovers from transactions that constitute a plan,[61] the broad and ambiguous language of the statute may support a reading that hostile bids pending before a spin-off constitute a preconceived plan to sell stock.[62] The rationale for not excluding hostile takeovers may have been the difficulty in determining whether an acquisition is hostile or nonhostile, or at what point a hostile takeover attempt becomes nonhostile.[63] Some commentators take the position that a hostile takeover involving the distributing or controlled

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53. *See id.* at 376.

54. Silverman, *supra* note 42, at 330.

55. Ritt, *supra* note 41, at 573.

56. *See id.*

57. *See* Silverman, *supra* note 42, at 336 (surmising that even though the Code does not deal with this issue, the relevant plan is probably "either the plan of the distributing corporation, the controlled corporation, or 'significant' shareholders of the distributing corporation").

58. *See id.* at 335-36.

59. Robert Willens, *Another View of the ITT/Hilton Case,* Tax Notes, Mar. 9, 1998, at 1329, 1329.

60. *See id.* at 1330.

61. *See* Silverman, *supra* note 42, at 336.

62. *See, e.g.,* Hilton Hotel Corp. v. ITT Corp., 978 F. Supp. 1342, 1350 (D. Nev. 1997) (reasoning that ITT's hostile takeover plan would force shareholders to sell off shares before the spin-off).

63. *See* Willens, *supra* note 59, at 1329.

corporation after the completion of a spin-off would be disregarded as an "unrelated" transaction.[64] This may not always be the case.

In *ITT Corp. v. Hilton Hotels Corp.*,[65] the Ninth Circuit observed that the broad language of section 355(e) may support a different reading of the term "plan." *ITT Corp.* raised the issue of whether section 355(e) would require gain recognition by a distributing corporation if the distributing corporation spun off its subsidiary while a hostile takeover bid was pending and the takeover succeeded thereafter.[66] Hilton Hotels Corp. ("Hilton"), the hostile bidder in the case, announced a $55 per share tender offer for the stock of ITT Corp. ("ITT"), that ITT formally rejected. ITT then proceeded to prepare a restructuring plan to split the corporation into three entities and spin off its hotel and gaming businesses, which were the target of Hilton's offer.[67] Subsequently, Hilton filed a suit to obtain an injunction to prevent the implementation of ITT's plan.[68] In the suit, Hilton contended that ITT's plan included a poison pill that would result in a tax liability of $1.4 billion to Hilton if Hilton were to successfully acquire more than 50% of the stock of ITT's subsidiary.[69] In addition, an expert witness retained by Hilton submitted an affidavit to the court, stating that there was a "likelihood that a post-distribution acquisition by Hilton of [the subsidiary] would be deemed part of a 'plan' or 'series of related transactions,'"[70] which would give rise to a recognition of gain under section 355(e). In granting Hilton's request for an injunction, the court noted that the record before it fairly supported Hilton's position that Hilton would be liable for 90% of the $1.4 billion tax liability pursuant to a tax sharing agreement arranged by ITT.[71]

The ambiguous language of section 355(e) thus supports the following proposition: even though an acquisition following a spin-off that does not involve any discussion or negotiation will likely rebut the two-year presumption, an unsolicited offer in which the suitor en-

64. *See* Silverman, *supra* note 42, at 13. According to the author, a change of ownership facilitated through public trading would also be disregarded. *See id.*

65. 978 F. Supp. 1342 (D. Nev. 1997).

66. *See* Bernard Wolfman, *Special Report Put Odd Spin on Section 355(e)*, Tax Notes, Jan. 26, 1998, at 477.

67. *See ITT Corp.*, 978 F. Supp. at 1344.

68. *See id.* at 1342.

69. *See id.* at 1344.

70. Wolfman, *supra* note 66, at 4; *see also* Willens, *supra* note 59, at 1330 (noting that in *Hilton* there was more than negligible risk that Hilton's acquisition of ITT's subsidiary subsequent to the subsidiary's spin-off could have been construed as a device and would have triggered a section 355(e) gain); Bernard Wolfman, *Setting the Record Straight on ITT/Hilton Case*, Tax Notes Today, Feb. 17, 1998, *available* in LEXIS, FedTax Library, TNT File (defending author's position regarding ITT/Hilton litigation). *But see* Mark J. Silverman et al., *Spin-offs: The Rest of the Story*, Tax Notes, Feb. 9, 1998, at 762 (arguing that the court in *ITT Corp. v. Hilton Hotels Corp.* did not analyze section 355(e), and that it was unclear which section of the Code governed the trigger of gain).

71. *See ITT Corp.*, 978 F. Supp. at 1344.

gaged in a discussion with the target's shareholders prior to a spin-off may constitute a plan if a sale of stock was reasonably anticipated by the shareholders.[72] If the Code's focus is on the distributing corporation's shareholders' plan, then the above result makes sense, albeit in a strange way. Because significant shareholders of a distributing corporation have influence over transactions entered into by the corporation, it seems logical that the shareholders' plan would be relevant for section 355(e) purposes.[73] If the focus is on the acquirer's plan, however, the result makes no sense because the acquirer, acting alone, has no influence over the spin-off.[74] Neither the Code nor the accompanying regulations provide guidance with respect to this issue.

Another problematic aspect of section 355(e) is the phrase "any controlled corporation" used when discussing the acquisition of a 50% or greater interest in either the distributing or controlled corporation that would lead to gain recognition.[75] As the provision now reads, if a parent corporation spins off two or more subsidiaries and subsequently one of them is acquired by an unrelated party, it is unclear whether the parent will have to recognize gain with respect to all the subsidiaries that were spun off.[76] In addition, there is some concern whether the word "any" may also apply to those subsidiaries that were not spun-off, but were acquired by an unrelated party after the parent spun-off another subsidiary.[77]

Finally, in the event that a corporation must recognize a gain, the Code fails to provide for a corresponding adjustment to the basis of the stock or assets of either corporation by the amount of the gain recognized.[78] The omission of a basis adjustment provision is not the result of mere oversight, however, since the Conference Report to the Taxpayer Relief Act of 1997 ("TRA 1997") specifically precludes any basis adjustment resulting from gain recognition.[79]

II. IMPROPER MOTIVES FOR SPIN-OFFS AND NON-TAX LAW DETERRENTS

Not all reasons for spin-offs are legitimate, of course, and the law must prevent corporations from effecting spin-offs for improper motives. Adequate safeguards outside the tax laws, do exist, however, to deter corporations from carrying out improper spin-offs. Shareholder suits have proven to be effective deterrents and remedies to corpora-

72. *See* Willens, *supra* note 59, at 1329.
73. *See* Silverman, *supra* note 42, at 336.
74. *See id.*
75. *See id.* at 338.
76. *See id.*
77. *See id.*
78. *See id.*
79. H.R. Conf. Rep. No. 105-220, at 531-32 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1339, 1343-44.

tions that use spin-offs as takeover defenses for purposes of management entrenchment, as discussed above in the context of the Hilton/ITT example.[80] State fraudulent conveyance laws have been equally effective in preventing spin-offs effected to avoid liability for tort claims in lawsuits pending or threatened. This section explores these safeguards in-depth and concludes that the efficacy of these laws obviates the need for the overly burdensome restraints of section 355 and the surrounding regulations and rulings that too often disallow legitimate spin-offs.

A. *Takeover Defense*

Spin-offs sometimes discourage hostile takeovers and, therefore, corporate managers intent on entrenching themselves may abuse them.[81] A spin-off makes a takeover more difficult for several reasons. First, it makes the targeted company less desirable to the bidder because a takeover of either the parent or the subsidiary following a spin-off may generate a large tax liability.[82] Second, a spin-off will typically drive up the stock price[83] of the parent or subsidiary, forcing the takeover bidder to either raise the offer or go away. Third, the newly spun off entity can be structured with strong defense mechanisms such as a poison pill, classified board, indemnity agreement, or golden parachute provision.[84] Finally, if a bidder desires all of a company's assets, the spin-off takes part of what the bidder covets out of reach,[85] or at least forces the bidder to make two tender offers instead of one.

Spin-offs are an issue in takeover defenses, however, only in limited circumstances.[86] Although corporate managers sometimes use spin-offs as part of a defense plan, spin-offs are not defense tools in and of themselves. The mere proposal of a spin-off will usually not deter a takeover unless that proposal is used in conjunction with conventional

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80. *See supra* notes 65-71 and accompanying text.

81. *See, e.g.,* Wander et al., *supra* note 3, at 3 (discussing motivations behind the Cole Taylor Financial Group spin-off).

82. A corporation faced with a hostile bid may choose to spin off a new corporation and enter into an indemnity agreement against the risk of taxation under 355(e), thereby threatening the raider with significant tax liability should it proceed with the takeover. *See* Freeman et al., *supra* note 4, at 138-39.

83. *See infra* notes 309-15 and accompanying text (discussing how spin-offs generate higher stock prices).

84. *See* Freeman et al., *supra* note 4, at 138-39.

85. A classic defense tactic is to spin-off a company's "crown jewels" to take them out of the bidder's reach. *See, e.g.,* Buckley, *supra* note 1, at 810 (arguing that divestment of crown jewels for entrenchment purposes is value-decreasing and should be prohibited).

86. Takeover law in Delaware and most other states permits a myriad of defense tactics which are much more effective anti-takeover tools than spin-offs. Spin-offs enter into play only in unusual circumstances where these measures alone were not sufficient.

takeover defense devices, such as poison pills.[87] When spin-offs are used as part of a defense plan, they are generally proposed in the face of an existing or impending tender offer.[88] Sometimes, however, the spin-off is planned ahead of time, and the tender offer comes unexpectedly before the spin-off is completed.[89] In either case, directors are put in the position of choosing between the spin-off or the tender offer.

As part of its fiduciary duties, a board of directors should choose the alternative that brings shareholders a higher premium.[90] The best option is not always readily apparent, however, because the choice is between the specified premium of the tender offer and the hypothetical return of the spin-off. The decision is further complicated by an inherent conflict of interest: board members have a natural incentive to disfavor a tender offer because acceptance of the offer may put them out of work.[91] There is thus the potential for a board to use a spin-off as a pretext for refusing to allow shareholders to vote on a tender offer.[92] Spin-offs are potentially abusive, however, only because state anti-takeover laws, as a general rule, fail to protect shareholder interests sufficiently.[93] Because spin-offs are at issue in limited circumstances in the takeover context,[94] abusive spin-offs are not likely to occur very often. Furthermore, in those cases where the potential for abuse does exist, other legal safeguards act as strong deterrents.[95]

Specifically, the standards developed by courts to review a board of directors' decision to reject a tender offer provide sufficient protection to shareholders. Courts judge such a decision by a test roughly equivalent to soft intermediate scrutiny.[96] A board must determine

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87. A spin-off takes time to complete, where a tender offer can be put together quickly. Thus, absent a poison pill or other device which prevents a shareholders vote on the offer, the spin-off has little defense value.

88. *See, e.g.*, Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1052 (Del. Ch. 1988) (discussing an attempt by Pillsbury to avert a takeover).

89. An example is Commercial Intertech's spin-off of Cuno discussed at *infra* notes 214-17 and accompanying text.

90. For a discussion of the effects of tender offers on stock prices see Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management In Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1165-68 (1981).

91. *See* Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985).

92. This danger is not very serious. *See infra* notes 96-97 and accompanying text.

93. Generally, state anti-takeover law permits a board of directors to employ a myriad of defenses which interfere with shareholders' rights to sell their shares directly to a bidder. *See, e.g.*, Timothy B. Wheeler, *Bid to Fight Takeovers Criticized; Planned Bill to Protect Maryland Firms for a Favored View, Some Say*, Balt. Sun, Jan. 17, 1999, at 1D (discussing debate over governor's initiative to help prevent state-based businesses from takeover).

94. *See supra* notes 89-91 and accompanying text.

95. *See infra* Part II.B.1-3.

96. For simplicity purposes, this section discusses Delaware anti-takeover law, which is widely followed by state courts around the country.

that the offer presents a danger to corporate policy or effectiveness and must respond to the threat with measures that are reasonable in relation to the threat posed.[97] The board satisfies this test if it makes its decision in good faith and after a reasonable investigation of the offer.[98] While this test is not stringent generally,[99] in the spin-off context it offers reasonable protection for shareholders, as the recent Pillsbury/Burger King attempted spin-off illustrates. In this case, Grand Metropolitan ("Grand Met") made a cash tender offer of $63 per share for Pillsbury's stock. Pillsbury's board of directors rejected Grand Met's offer[100] in favor of a business plan that included spinning off Burger King.[101] Grand Met and Pillsbury shareholders successfully sued to force Pillsbury's board to redeem its poison pill, thereby allowing shareholders to accept the offer that paid them a 60% premium.[102]

In attempting to block such a lucrative offer, Pillsbury's board displayed callous disregard for Pillsbury's shareholders, who overwhelmingly favored the tender offer.[103] The proposed Burger King spin-off, which came only after the tender offer was announced, appears to have been a pretext for rejecting the offer rather than a le-

97. *See* Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 954-56 (Del. 1985).

98. *See id.* at 955. Proof of good faith and reasonable investigation is materially enhanced where the majority of the board members who voted to reject the offer are "outside independent directors." *Id.*

99. The problem with the test is that an unscrupulous board can meet the requirements too easily. Delaware courts permit a wide-range of factors to constitute such a threat to corporate policy and effectiveness including "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the general community), the risk of nonconsummation, and the quality of securities being offered in the exchange." *Id.* at 955. The "impact on constituencies other than shareholders" allows considerable leeway for a board to reject an offer that would otherwise be very good for shareholders. Furthermore, some states have expanded the board's discretion by statute. Minnesota's Business Corporation Act, for example, states that:

> a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation.

Minn. Stat. § 302A.251 (1985 & Supp. 1999). Under this statute, virtually any excuse would suffice to justify a board's rejection of a tender offer.

100. The rejection came by virtue of the board's refusal to withdraw its poison pill which in turn prevented a shareholder vote on the offer. *See* Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1050 (Del. Ch. 1988).

101. *See id.*

102. Grand Met announced the tender offer on October 4, 1988. On September 30, 1988 the stock traded at $39 per share. *See id.* at 1052.

103. By the time the case got to court (approximately two months after the tender offer), 87% of Pillsbury's stockholders had tendered their shares pending removal of the poison pill. *See id.* at 1058.

gitimate attempt to enhance shareholder value.[104] This case demonstrates that a board favoring a spin-off over a tender offer will have to produce at least moderately persuasive evidence that the spin-off will be as good or better for the shareholders.[105] If such evidence is lacking, the bidder is likely to obtain injunctive relief. In addition, in light of the *Pillsbury* decision, a board is likely to think twice about thwarting a takeover with an illegitimate spin-off because of the potential for massive liability. Pillsbury's board was fortunate that Grand Met sued for injunctive relief as opposed to withdrawing its offer. A withdrawal of the bid, in all likelihood, would have driven the stock price down to its pre-offer level of $39 per share or below.[106] A shareholder lawsuit against the board for breach of fiduciary duties[107]

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104. The Pillsbury board maintained the "true value" of its stock was $68 and claimed to have a business plan that would eventually bring the stock up to that price (four or five years later). *See id.* at 1057. The court was thus highly skeptical noting that "Pillsbury has been in a defensive mode since May 1988 and at various times since then it has, in addition to organizing a team of investment bankers and lawyers, explored or investigated many corporate alternatives, including recapitalization and a possible combination with each of about 15 different white knights." *Id.* The court focused on the hypothetical nature of the Pillsbury's plan concluding:

> the bottom line in Pillsbury's plan is that, on a per share basis, the present minimum value (according to its experts) is $68—and to realize that, a shareholder will have to be patient and endure for a long time, perhaps until 1992 or 1993. Moreover, Pillsbury's corporate performance must improve substantially in the future if it is to earn and receive (in the sales which are planned) the premiums that are the predicate for its optimistic forecasts. And a shareholder could well conclude that his/her Company's recent performance renders quite ambitious the assumptions upon which future hypothetical value is premised. In all events, expectancies over a four or five year period out into the nineties are subject to economic and competitive conditions which are beyond Pillsbury's control.

Id.

105. Pillsbury lost because it failed to produce convincing evidence of a plan that offered stockholders comparable value. *See id.* at 1058. Note, however, that a comparison between the merits of a spin-off and the merits of a tender offer will come into play only where the sole threat to corporate policy and effectiveness is inadequacy of price. *See id.* at 1056 ("Whatever threat involved relates entirely to the alleged 'inadequacy of the price offered' to Pillsbury stockholders."). In other words, if Pillsbury's board had identified a genuine threat to corporate policy and effectiveness other than inadequacy of price, the merits of a proposed spin-off may not have been an issue in the case. Pillsbury could have rejected the offer on the basis of the threat and would not have needed to even bother proposing the spin-off. Because the definition of threat to corporate policy and effectiveness is broad, an unscrupulous board wishing to entrench itself need only invent an excuse which fits the definition. Spin-offs are not effective entrenchment devices because they invite an analysis which compares the financial merits of the spin-off versus the price of the tender offer. Thus, spin-offs are likely to deter tender offers only where the spin-off is indeed better for shareholders.

106. *See id.* at 1058 ("If the Pill remains at the end of this litigation and if the Tender Offer is withdrawn, the uncontested affidavits [from investment bankers] show that the price of Pillsbury's stock will fall into the high 30's—a drop of about $25 per share for some 76,000,000 shares.").

107. The test used to determine whether the duties were breached was the *Unocal* test discussed *supra* at notes 97-101 and accompanying text. This is the same test the

would undoubtedly have followed. If a court found that a breach had occurred, as it likely would have,[108] the board would have been liable to shareholders for the difference between the offering price and the stock price after withdrawal, roughly $24 per share. Pillsbury had 76 million shares outstanding, putting the board's potential liability in the neighborhood of $1.9 billion.[109] The threat of a shareholder lawsuit is thus likely to deter a board from turning away a generous tender offer in favor of a spin-off unless it is reasonably confident the spin-off will bring shareholders equivalent value.[110]

B. *Avoiding Liability*

One line of a corporation's business may, at times, place its other lines of business at risk. For example, a reputable financial services firm's image and stock price can be damaged if a particular division incurs large losses or over-exposes itself to certain liabilities, even though the overall health of the firm is strong. Similarly, a company may find that a certain line of business carries potential environmental or other tort liabilities that make its shareholders uncomfortable. In such situations, spin-offs are a possible solution.

Revenue Procedure 96-30 does consider risk reduction a valid business purpose for a spin-off.[111] Proving the risk to the IRS may be difficult,[112] however, and the parent corporation will have to provide the new entity with enough reserves to cover its liabilities.[113] Moreover, a parent needs to exercise care in negotiating a fair separation agreement with the subsidiary, as spin-offs executed to avoid liability carry risks involving post spin-off litigation, state fraudulent conveyance laws, and public disclosure requirements.[114] These risks ordinarily militate against a company spinning off its liability-laden businesses without regard for the consequences. Companies that fail to negotiate reasonable and fair terms of separation with a subsidiary may find

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court used in *Grand Metro. See id.* at 1055-56.

108. Pillsbury lost in an action for injunctive relief where the court in essence said that leaving the pill in place would constitute a breach of fiduciary duties. *See id.* at 1055-57.

109. *See id.* at 1058.

110. The reader may wonder why Pillsbury's board acted as it did given the potential liability. The board was apparently operating under the assumption that its actions would be judged by the more lenient standard of the business judgment rule. Pillsbury raised this argument unsuccessfully in court. *See id.* at 1059. Now that the Delaware Supreme Court has articulated a more stringent standard, the typical board will likely think twice before mimicking the Pillsbury board's reckless behavior.

A spin-off, however, can be a legitimate alternative to a tender offer, as in the Commercial Intertech spin-off of Cuno discussed below. *See infra* notes 219-22 and accompanying text.

111. *See* Rev. Proc. 96-30, 1996-1 C.B. 696, 712; Wilson, *supra* note 22, at 111.

112. *See* Freeman et al., *supra* note 4, at 1157.

113. *See* Wander et al., *supra* note 3, at 318-19.

114. *See id.* at 319.

themselves in the same position as Household International Inc. ("Household"), a parent corporation which paid $27 million to settle a suit from a former subsidiary that alleged that Household left it with inadequate reserves to cover products liability claims.[115]

For corporations facing mass tort claims, the temptation to avoid liability by spinning off culpable subsidiaries may be quite strong. Moreover, the amount of potential liability in mass tort cases makes it virtually impossible for a parent corporation to provide the spun off subsidiary with adequate reserves to cover potential judgments. Under such circumstances, spin-offs are improper. Several recent mass tort cases have, however, demonstrated the efficacy of state fraudulent conveyance laws in preventing or invalidating spin-offs improperly effected to avoid liability.

1. Tobacco Litigation and State Fraudulent Conveyance Laws

Carl Icahn, a well-known corporate raider,[116] recently ended a two-year battle in which he attempted to force RJR Nabisco ("RJR") to separate its food business from its tobacco business.[117] Icahn believed that spinning off RJR's food business would unlock shareholder value because a spin-off would essentially create a "firewall" between the tobacco and non-tobacco businesses, thus shielding the assets of the non-tobacco businesses from plaintiffs obtaining judgments against RJR for tobacco-related injuries.[118] Many investors and analysts agreed that a spin-off of RJR's food business would create a tremendous amount of value for RJR shareholders.[119] Some even argued that "the potential rewards to shareholders could run into the billions of dollars."[120] In spite of these numbers, Icahn's quest to separate RJR's food and tobacco business was consistently blocked by the directors of RJR[121] who realized that a spin-off would be challenged by

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115. *See id.* at 319-20.

116. *See* Andrew Serwer, *Who's Afraid of Carl Icahn?*, Fortune, Feb. 17, 1997, at 104, 104 (stating that Carl Icahn and Bennett LeBow are well-known corporate raiders who owned $600 million and $95 million worth of stock, respectively, in RJR Nabisco before Icahn sold his shares).

117. *See Icahn Sells RJR Nabisco Holding for $813.5m*, Financial Times (London), June 16, 1999 at 38 (noting that Icahn sold his stake in RJR Nabisco, giving up his fight to separate the companies).

118. *See* John F. Olson & D. Jarret Arp, *The Year of the Proactive Director: Recent Developments in* The Performance and Compensation of Outside Directors 1995, at 571, 746 (PLI Corp. L. and Prac. Course Handbook Series B4-7086, 1995) (noting that a spin-off is attractive to those concerned with limiting the potential liability and regulatory risks to tobacco companies).

119. *See* Serwer, *supra* note 116, at 104, 106 (noting that every Wall Street analyst sees that a spin-off of RJR's tobacco business would benefit shareholders); *see also* Jennifer Fischl, *RJR Nabisco: Split Indecision*, Fin. World, Dec. 16, 1996, at 22 ("[M]any investors feel that shares of both RJR as well as Nabisco Holdings will trade much higher" if the tobacco business is separated.").

120. Serwer, *supra* note 116, at 104.

121. *See id.* (discussing management's rejection of Icahn's proposed spin-off).

plaintiffs in tobacco-related lawsuits as a fraudulent conveyance. Plaintiffs in a tobacco related litigation could argue that RJR's spin-off was intentionally fraudulent because it was conducted with the intent to delay, hinder, and defraud tort creditors.[122] In addition, these plaintiffs could contend that the spin-off was constructively fraudulent because RJR received less than the reasonably equivalent value for the property transferred in the spin-off, and that the company was insolvent at the time of the transfer and intended to incur debts beyond its ability to pay them.[123] Litigating these claims would have cost RJR

122. *See* Unif. Fraudulent Transfers Act § 4(a)(1), 7A U.L.A. 301 (1984) [hereinafter UFTA]; *see also* F. John Stark, III et al., *"Marriott Risk": A New Model Covenant to Restrict Transfers of Wealth From Bondholders to Stockholders*, 1994 Colum. Bus. L. Rev. 503 ("A transfer... may be deemed a fraudulent conveyance if it is made with actual intent to hinder, delay or defraud creditors without regard to the financial condition of the transferor."). Section 4 of the UFTA, which applies to both present and future creditors, covers intentionally fraudulent transfers and states that a transfer is fraudulent if it was made "with actual intent to hinder, delay, or defraud any creditor of the debtor." UFTA § 4(a)(1) (1984). Establishing actual intent to hinder, delay, or defraud creditors requires a court to inquire into the debtor's subjective state of mind at the time of the transfer. *See* Jeffrey Bigelow Design Group, Inc. v. First Am. Bank of Md., 956 F.2d 479, 483-84 (4th Cir. 1992). Because direct evidence of actual intent is typically not available, section 4(b) of the UFTA lists certain "badges of fraud" that can establish the debtor's actual intent. Factors among this nonexclusive list include:

> (1) whether the transfer was made to an insider; (2) whether the debtor retained possession or control of the property transferred; (3) whether the transfer was disclosed or concealed; (4) whether the debtor had been sued or threatened with suit before the transfer; (5) whether the transfer was of substantially all of the debtor's assets; (6) whether the debtor was insolvent or became insolvent shortly after the transfer was made; and (7) whether the transfer occurred shortly before or after a substantial debt was incurred.

UFTA § 4(b). While evidence of a single "badge of fraud" usually does no more than raise a suspicion of a fraudulent conveyance, the presence of several creates an inference of an improper motive. *See* Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254-55 (1st Cir. 1991).

123. *See* UFTA §§ 4, 5 (outlining transfers that are constructively fraudulent). Section 4 of the UFTA also establishes two situations in which a transfer is constructively fraudulent. The first situation is where the transferor received less than reasonably equivalent value in exchange for the transfer and was engaged in or was about to engage in a business for which its remaining assets were unreasonably small in relation to the business or transaction. *See id.* § 4(a)(2)(i). If a creditor proves that the transferor received less then reasonably equivalent value for the transfer, courts then analyze the issue of unreasonable capital under three varying approaches. *See* Pajaro Dunes Rental Agency, Inc. v. Spitters, 174 B.R. 557, 591 (Bankr. N.D. Cal. 1994) (outlining the three approaches). Some courts use a per se rule that focuses on whether the debtor was solvent at the time of the transfer. *See, e.g.*, Spanier v. U.S. Fidelity & Guar. Co., 623 P.2d 19, 24 (Ariz. Ct. App. 1980) (holding that if the debtor was insolvent at the time of the transfer, the debtor has "unreasonably small capital per se").

Other courts use a more relativistic, case-by-case approach. *See, e.g.*, Barrett v. Continental Ill. Nat'l Bank & Trust Co., 882 F.2d 1, 4 (1st Cir. 1989) (finding "unreasonably" a relative term for the purposes of section 5 of UFTA). Under this approach, courts weigh the financial data of a company's balance sheet against the nature of the entity and its need for capital over time. *See id.* The third approach focuses on the debtor's future ability to generate cash and pay its debts as they come millions of dollars, and an adverse ruling would have meant that if RJR had ever filed for bankruptcy due to massive tort liability the spin-off would have been deemed illegal.[124]

Other tobacco companies have also considered corporate spin-offs as a means of limiting their liability. The tobacco holding companies Kimberly-Clark Corp., American Brands, Inc., Loews Corp., and Philip Morris Inc. received requests from shareholders to spin off their tobacco businesses from their other consumer businesses.[125] In fact, American Brands, Inc. and Kimberly-Clark Corp. both announced that they would spin off their tobacco businesses.[126] While these proposed spin-offs were in part due to business decisions unrelated to the tobacco litigation,[127] the pending threat of mass tort liability undoubtedly prompted these companies to consider spin-offs in order to shield the assets of other non-tobacco businesses.[128] That they all chose not to proceed with their proposed spin-offs demonstrates the effectiveness of state fraudulent conveyance laws, particularly in light of recent precedent-setting decisions in environmental liability and asbestos cases.

2. Fraudulent Conveyance Claims in Environmental Cases

In recent years, federal and state governments have enacted strict

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due and still remain financially stable. *See, e.g.*, Moody v. Security Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992) (inquiring whether the parties' projections were reasonable). Under all three approaches, a court must recreate the financial condition of the company at the time of the transfer. *See Pajaro Dunes*, 174 B.R. at 591.

124. *See* Fischl, *supra* note 119, at 22. In June 1999, after selling its international tobacco business, RJR Nabisco separated its domestic tobacco business from its food business in a tax-free spin-off. RJR Nabisco continues to exist as a holding company, renamed Nabisco Group Holdings. *See RJR Nabisco Agrees to Sell International Tobacco Business for $8 Billion; Board Approves Spin-off Plan for Domestic Tobacco Company*, Nabisco Group Holdings (visited Sept. 9, 1999) <http://www.rjrnabisco.com/news/19990309-7092.htm>. Nabisco Group Holdings will, however, remain liable in tobacco related lawsuits for any potential past misconduct of the recently spun-off tobacco business. *See The Barbarians Are No Longer at the Gate*, U.S. News & World Report, Mar. 22, 1999, at 50.

125. *See* Olson & Arp, *supra* note 118, at 745.

126. *See American Brands to Spin Off Tobacco Business*, 10 Mealey's Litig. Rep. (Tobacco) 32, Oct. 17, 1996 (announcing American Brands Inc.'s plan to spin off its tobacco business in the United Kingdom); *see also* Olson & Arp, *supra* note 118, at 747 (noting that the Kimberly-Clark Corp. recently announced plans to spin off its tobacco related business).

127. In announcing its spin-off, American Brands, Inc. stated that "[t]he spin-off will allow the managements of the two companies to focus exclusively on strategies and objectives geared to the very different financial, investment and operating characteristics and growth potential of their companies." *American Brands to Spin Off Tobacco Business*, *supra* note 126, at 32.

128. *See* Glenn Collins, *Paper Maker to Spin Off Tobacco Units*, N.Y. Times, May 10, 1995, at 1 (stating that Kimberly-Clark Corp.'s spin-off was prompted by shareholders' concern over the legal liabilities of cigarettes).

environmental laws. Some companies have attempted to restructure themselves in order to shield their assets from environmental liability,[129] because of the extensive liability under environmental laws.[130] They have used spin-offs as a means of restructuring. Nevertheless, creditors have successfully challenged these spin-offs as fraudulent conveyances.[131]

The leading case dealing with corporate spin-offs in the wake of massive environmental liability is *Kelley v. Thomas Solvent Co.*[132] The Thomas Solvent Co. ("Solvent") was engaged in the distribution and transportation of industrial solvents in five separate facilities, two of which were operated in the Battle Creek, Michigan area.[133] In 1981, environmental tests of the water supply in the Battle Creek area disclosed that the water supply was contaminated with volatile organic compounds.[134] In January 1982, the Michigan Department of Natural Resources ("MDNR") informed Solvent that it was suspected of contaminating the groundwater based on tests that revealed that its wells contained the same compound found in the water supply.[135] Facing possible massive environmental liability for contaminating the groundwater, Solvent reorganized its company by conveying the majority of its assets to four spin-off corporations.[136] This move greatly reduced Solvent's assets.[137] In conducting the spin-offs, the company stated that one reason for the restructuring was a concern about potential environmental liability.[138] The company also noted that "a number of other reasons supporting the reorganization, including flexibility in compensation, tax benefits, better dealings with union shops, and protection of assets in the event of a future catastrophic accident."[139]

The State of Michigan and the United States brought suit against Solvent, claiming that the transactions were intentionally and constructively fraudulent conveyances.[140] The district court agreed with

129. *See, e.g.*, United States v. Vertac Chem. Corp., 671 F. Supp. 595, 618 (E.D. Ark. 1987) (finding that corporation faced with environmental liability transferred its assets to avoid environmental liability), *vacated on procedural grounds*, 855 F.2d 856 (8th Cir. 1988).

130. *See* Kathryn E.B. Robb, *Environmental Considerations in Project Financing*, *in* Project Financing 1993: Domestic and International 1993, at 565, 577 (PLI Com. L. and Prac. Course Handbook Series No. A-672, 1993) (noting that Superfund created billions of dollars in potential liability for American businesses).

131. *See* Kelley v. Thomas Solvent Co., 725 F. Supp. 1446, 1452-53 (W.D. Mich. 1988).

132. *See id.*

133. *See id.* at 1448.

134. *See id.*

135. *See id.* at 1448-49.

136. *See id.* at 1450.

137. *See id.*

138. *See id.* at 1449.

139. *Id.* at 1449-50.

140. While the case only addresses the intentional fraud claim, the plaintiffs as-

the plaintiffs and ruled that the spin-offs were intentionally fraudulent.[141] The court based its ruling on statements made by the directors of the company which indicated that the decision to authorize the spin-offs was motivated by concern about environmental liabilities associated with the Battle Creek groundwater.[142] The court rejected the defendant's argument that the spin-offs were not fraudulent because the company had other motives, stating that "[a]ctual intent under the fraudulent conveyance statute exists when a corporation's decision to create one or more new corporations is motivated wholly or in part by a desire to hinder, delay, or defraud creditors."[143] In addition to finding intent to defraud, the court held that the State of Michigan and the United States had standing to challenge the spin-offs because both became creditors of Solvent as soon as they began to incur costs associated with the contaminated groundwater.[144] It also noted the existence of several "badges of fraud" such as: "a lack of consideration for the conveyance, a close relationship between transferor and transferee, pendency or threat of litigation, financial difficulties of the transferor, and retention of the possession, control, or benefit of the property by the transferor."[145] Furthermore, the court indicated that even in the absence of the statements made by the directors of the company, these badges of fraud would have provided sufficient evidence of actual fraud.[146]

United States v. Vertac Chemical Corp.[147] is another major case addressing the issue of a fraudulent conveyance in the wake of massive environmental liability. The United States and the State of Arkansas filed suit against Vertac Chemical Corp. ("Vertac") for environmental violations.[148] In 1986, Vertac entered into a stipulation with the United States and Arkansas under which Vertac was permitted to spin off several of its assets in exchange for agreeing to pay almost $14 million in environmental damages.[149] After the spin-off, Vertac owned the plant that was responsible for the environmental damage and a profitable pesticide marketing operation.[150] In early 1987, Vertac sold its pesticide marketing operation to a corporation owned by

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serted both intentional and constructive fraud claims. *See* Stewart H. Freeman, *Responsibility of the Corporate Parent for the Activities of a Subsidiary: Corporate Exposure for Environmental Claims*, *in* Responsibility of the Corporate Parent for the Activities of a Subsidiary 1988, at 111, 150, 162 (PLI Corp L. and Prac. Course Handbook Series No. B4-6834, 1988) (reprinting plaintiffs' brief).

141. *See Kelley*, 725 F. Supp. at 1456.

142. *See id.* at 1453-55.

143. *Id.* at 1455.

144. *See id.* at 1456.

145. *See id.* at 1457 (citations omitted).

146. *See id.*

147. 671 F. Supp. 595 (E.D. Ark. 1987).

148. *See id.* at 595.

149. *See id.* at 611.

150. *See id.* at 604.

Vertac's president and sole director for $1.675 million.[151]

In *Vertac Chemical Corp.*, the United States and the State of Arkansas challenged the transfer as an intentionally and constructively fraudulent conveyance.[152] The district court ruled in favor of the plaintiffs on both claims. The court found that the transfers were intentionally fraudulent because several badges of fraud were present: (1) Vertac was insolvent and indebted to the United States and Arkansas at the time of the spin-off; (2) various lawsuits were pending against Vertac; (3) the transactions were concealed; and (4) the sale was not for fair market value and not in the ordinary course of Vertac's business.[153] It also found the transfer to be constructively fraudulent because $1.675 million for the business was less than reasonably equivalent value.[154] Furthermore, Vertac was insolvent at the time of the transfer, had no property to carry on the business after the transfer, and incurred debts beyond its ability to pay.[155]

3. Fraudulent Conveyance Claims in Asbestos Litigation

Throughout the 1980's, companies producing asbestos products faced massive tort liability similar to the liability that tobacco companies have recently faced. For example, Raymark Industries, a company that manufactured asbestos and asbestos-containing products, had claims exceeding $33 billion pending against it in 1988.[156] One strategy that companies such as Raymark Industries used in an attempt to limit their liability was to spin off divisions of their companies that produced asbestos-related products to shield their other businesses from liability.[157] While much of the litigation surrounding asbestos related injuries was either settled out of court or is still ongoing, courts have addressed the issue of whether these corporate spin-offs were fraudulent conveyances.

The most instructive case dealing with corporate spin-offs in the wake of massive asbestos liability is *Schmoll v. Acands, Inc.*[158] The defendant, Raymark Industries, had been a profitable business until asbestos-related claims filed against it caused the net worth of the com-

151. *See id.* at 604-05.
152. *See id.* at 618.
153. *See id.*
154. *See id.*
155. *See id.*
156. *See* Schmoll v. Acands, Inc., 703 F. Supp. 868, 873 (D. Or. 1988).
157. *See, e.g., id.* at 873-74 (restructuring of Raymark Corp. to allow "new business opportunities to grow, unshadowed by the cloud of asbestos liability" (citation omitted)).
158. 703 F. Supp. at 868. Although *Schmoll* was decided on corporate successor liability principles, the court noted that if the plaintiffs were attempting to set aside the transaction rather than attempting to hold the successor corporation liable, the court would have used the same rationale in finding that the transaction constituted a fraudulent conveyance. *See id.* at 874 n.11.

pany to drop dramatically.[159] As a result of this financial decline, Raymark Corp. (the parent company of Raymark Industries) reorganized its corporate structure through a series of complex transactions.[160] First, Raymark Corp. conveyed its two lucrative businesses that were not subject to asbestos claims to Raytech Corp.[161] Then Raymark Corp., which still held the businesses subject to asbestos liability, was sold to a company specializing in defending asbestos litigation.[162] Plaintiffs in *Schmoll* sought to hold Raytech Corp. liable for Raymark Industries' asbestos liability under the doctrine of successor liability, claiming that for purposes of liability the two companies were the same corporate entity.[163] It further noted that while a corporation normally does not assume the liabilities of a selling corporation, an exception exists when the corporations enter the transaction to escape liability.[164] The court stated that it would examine the substance of the transaction rather than the form to determine whether the transactions were carried out to escape liability.[165]

After examining the substance of Raymark Industries' reorganization, the *Schmoll* court concluded that the restructuring was designed to escape liability.[166] It noted that because Raymark Corp.'s valuable assets were conveyed to Raytech Corp., which was wholly owned by Raymark Corp.'s former shareholders, Raymark Industries was left with "staggering asbestos liabilities, unprofitable operations, unsecured notes, and stock which could not be sold in large blocks without a deep discount."[167] Moreover, statements made by the company suggested that it carried out its corporate restructuring to escape liability. In its 1985 annual report, Raymark Corp. indicated that part of its strategy was "to limit exposure for asbestos claims only to businesses currently threatened, thus enabling other businesses and any new business opportunities to grow, unshadowed by the cloud of asbestos litigation."[168] One high ranking board member of Raymark also stated that the restructuring was intended to "remove an asset through different ownership from the exposure of the asbestos litigation."[169]

Another asbestos-related adjudication dealing with fraudulent conveyance claims involves the continuing bankruptcy proceedings of Keene Corp. ("Keene"). Throughout the 1980's, Keene was named as

159. *See id.* at 869.
160. *See id.*
161. *See id.* at 871.
162. *See id.*
163. *See id.* at 872.
164. *See id.*
165. *See id.*
166. *See id.* at 874.
167. *Id.* at 873.
168. *Id.* at 873-74.
169. *Id.* at 874.

a defendant in a large number of asbestos-related lawsuits, which ultimately resulted in massive amounts of liability for the company.[170] In the midst of this litigation, Keene conducted several transactions between itself and certain affiliated companies, including Keene's former parent company Bairnco Corp. ("Bairnco") and five Bairnco wholly owned subsidiaries formed for the purpose of acquiring certain Keene assets.[171] Keene transferred over $200 million of its assets to these affiliates and spun off some of the affiliates, and thus reduced its assets.[172] As a result of these transfers, asbestos claimants filed two fraudulent conveyance actions against Bairnco and several of its affiliates involved in the transactions, claiming that these entities "embarked upon a plan to defraud Keene's asbestos creditors by restructuring Keene so as to put its profitable operations and assets with growth potential into new companies that they would continue to control but which would be beyond the reach of Keene's asbestos creditors."[173] These claimants asserted that as a result of the transactions Keene was stripped of its assets and left with little capital to deal with current and future asbestos liabilities.[174]

While these claims are still ongoing, some preliminary decisions in the case shed light on the fraudulent conveyance issue. In 1994, the judge overseeing Keene's bankruptcy proceedings ordered an independent examiner to evaluate the legitimacy of the fraudulent conveyance claims.[175] The court-appointed examiner concluded that the fraudulent conveyance claims were meritorious and should proceed because a fact finder would likely conclude that the transactions were carried out in an atmosphere of concern over Keene's asbestos liabilities.[176] The examiner noted that "a finder of fact could find that such transactions were motivated *at least in part* by an intent to hinder, delay or defraud creditors."[177] One important piece of evidence supporting this decision was a Bairnco document stating that "one additional element of [the restructuring] is that the new holding company structure may serve to isolate any new acquisitions from Keene's liabilities."[178]

170. *See* Keene Corp. v. Acstar Ins., 162 B.R. 935, 938 (Bankr. S.D.N.Y. 1994) (stating that by 1992 Keene Corp. had already incurred adverse judgments of over $83 million).

171. *See* Keene Corp. v. Coleman, 164 B.R. 844, 846-47 (Bankr. S.D.N.Y. 1994).

172. *See id.* at 846.

173. *Id.* at 847 (citation omitted).

174. *See id.* at 848.

175. *See id.* at 856.

176. *See Examiner's Report on Fraudulent Conveyance Claims Released*, 7 Mealey's Litig. Rep. (Asbestos Prop. Actions) 6, Oct. 28, 1994.

177. *Id.*

178. *See Fraudulent Conveyance Alleged Against Bairnco and Others*, 8 Mealey's Litig. Rep. (Asbestos) 10, Aug. 20, 1993.

III. LEGITIMATE BUSINESS RATIONALES FOR SPIN-OFFS

Despite the obvious tax benefits of spin-offs, companies pursue these transactions for a variety of reasons, most of which are consistent with directors' and officers' fiduciary duty to maximize shareholder value. This section explores the most prominent non-tax rationales for corporate spin-offs. Taken together, these legitimate motives suggest that spin-offs are not the bugaboo that the tax code makes them out to be, nor are directors and officers acting insidiously in proposing and effecting them. On the contrary, corporate managers who legitimately use spin-offs to enhance value concomitantly carry out their fiduciary duty to shareholders.

A. *Facilitating Acquisitions:* Morris Trust *Transactions*

Corporations have historically used spin-offs to remove obstacles to mergers, acquisitions, and other corporate transactions.[179] As discussed above, *Morris Trust* transactions enable a target corporation to spin off its unwanted assets into a new corporation, thereby leaving only the desired assets of the target for potential buyers.[180] In *Commissioner v. Morris Trust*,[181] a local bank used a spin-off to get rid of its insurance division. The spin-off enabled the bank to merge with a large national bank; a transaction which would otherwise have been prohibited by law since at the time national banks could not own insurance companies.[182] The driving force behind the deal was not tax avoidance, but the removal of a legal obstacle to merger.[183]

Indeed, despite the legitimate, non-tax reasons for most *Morris Trust* transactions, these transactions have become synonymous with tax avoidance.[184] After the repeal of the *General Utilities* doctrine in

179. *See* Stephen E. Wells, *Restructuring in Connection with Tax-Free Spin-Off Transactions*, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 1997, at 175, 206 (PLI Tax L. and Prac. Course Handbook Series No. J4-3690, 1997) (explaining how "spinoffs coupled with acquisitions" flourished following the *Morris Trust* court decision); *see also* Lynch, *supra* note 12, at 953-62 (discussing several transactions in which spin-offs have been used to facilitate transactions and the responses of the IRS and Congress to these deals).

180. The term *Morris Trust* comes from the case *Commissioner v. Morris Trust*, 367 F.2d 794, 794 (4th Cir. 1966). *See supra* notes 52-54 and accompanying text for a discussion of the structure of a *Morris Trust* Transaction.

181. 367 F.2d 794 (4th Cir. 1966).

182. *See id.* at 795; *supra* note 49.

183. The IRS eventually conceded, despite initial reluctance, that spin-offs are legitimate and non-abusive. After fighting and losing the *Morris Trust* case in court, the IRS issued Revenue Procedure 96-30 which lists "facilitating an acquisition of Distributing by tailoring Distributing's assets," as an acceptable business purpose. *See* Rev. Proc. 96-30, 1996-1 C.B. 696, 712.

184. *See* Scott E. Stewart, *New Rules for Spinoffs: An Analysis of Section 355(e)*, 51 Tax Law. 649, 651 (1998).

1986,[185] corporations found it far more difficult to dispose of appreciated property without tax consequences.[186] Section 355 spin-offs became the primary exception to the rule that all corporate distributions of property are subject to double taxation.[187] The spotlight was squarely on the tax-free aspect of spin-offs. A few high profile *Morris Trust* transactions generated negative publicity,[188] and Congress and the Treasury Department rushed in to close what they perceived as a tax loophole.[189] By focusing narrowly on media headlines[190] and a few questionable deals,[191] Congress neglected to consider that the traditional *Morris Trust* transaction had been a well-established and legitimate corporate practice for thirty years. Moreover, Congress failed to realize that *Morris Trust* transactions are not tax abusive but

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185. *See supra* notes 21-25 and accompanying text.

186. *See* Robert Willens, *New IRS Ruling Focuses Attention on 'Control'*, 89 J. Tax'n 5, 5 (1998) (discussing the favorable impact of the new IRS ruling).

187. *See supra* note 28 and accompanying text.

188. The deals included Disney's spin-off of its newspaper business and General Motor's sale of Hughes to Ratheon. Several media reports dubbed these deals tax free sales. *See generally* Allan Sloan, *The Loophole King*, Newsweek, Mar. 31, 1997, at 55 (noting Disney's $600 million in tax savings from strategic sale of the company's newspapers); *see also* Lee A. Sheppard, *GM Hopes Sale of Hughes to Raytheon Passes Section 355 Spin-Off Muster*, Tax Notes Today, Jan. 17, 1997 *available in* LEXIS, FedTax Library, TNT File (discussing GM's plan to sell its military electronics business in hopes of characterizing the sale as a section 355 tax-free spin-off); Lee A. Sheppard, *Rethinking Assumption of Liabilities in Spin-Offs*, Tax Notes Today, Feb. 13, 1997, *available in* LEXIS, FedTax Library, TNT File (describing PepsiCo's attempt to spin-off its unwanted restaurant businesses tax-free purportedly for legitimate business purposes under section 355 (e)).

189. House Ways & Means Comm. Chairman Bill Archer stated in his introduction to the proposed legislation that the bill was geared toward "prearranged structures designed to avoid corporate level gain recognition." *Intro. Statement to H.R. 1365* (later renumbered *H.R. 2014*), 105th Cong. 247 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1339, 1343-44. He further stated, "[i]n essence, these transactions resemble sales." *Id.* The Treasury Department echoed these concerns asserting that "corporate nonrecognition under section 355 should not apply to distributions that are effectively dispositions of a business." General Explanations of the Admin. Revenue Proposals, Dep't of the Treasury, *reprinted in* H & D, Feb. 7, 1997, at 1665.

190. *See supra* note 188 and accompanying text.

191. *See supra* note 188 and accompanying text. The New York City Bar Association conceded that some high profile deals did resemble sales and that it was fair to legislate to curb those kinds of deals. The Association distinguished illegitimate deals from traditional *Morris Trust* transactions.

> [W]e believe certain of these transactions arguably mandate a legislative response because they resemble sales at the corporate level. In these transactions, the business over which control is relinquished . . . borrowed significant amounts of cash and transferred the cash to the business over which control was retained. . . .Therefore, these transactions are economically similar to a sale by the retained corporation for cash of the business over which control is relinquished.

Letter of Sydney E. Unger, Chair of the Comm. on Taxation of Corps. of the Ass'n of the Bar of the City of N.Y., to Bill Archer, House Ways and Means Chair, and William V. Roth Jr., Senate Finance Chair (July 18, 1997), *reprinted in* Tax Notes, Aug. 4, 1997, at 693, 695.

"are motivated predominately by business concerns."[192]

These business concerns are not trivial. Prior to the enactment of section 355(e), the Tax Committee of the New York City Bar Association wrote to Congress warning that "[i]n many cases, the *Morris Trust* structure is the only economically viable way to structure a transaction in which two companies want to merge, and non-tax considerations mandate that one of the corporations dispose of one or more of its businesses."[193] Congress nevertheless enacted section 355(e), imposing a tax burden that makes spin-offs financially impractical in many cases.[194] As such, section 355(e) has deprived corporate managers of a previously available tool for facilitating value-enhancing deals that increase shareholder value.

B. *Increasing Revenue and Attracting Investors*

Spin-offs have also proven to be an effective means of raising capital for companies in need of funds for capital expenditures, research and development, expansion, and related business goals. The typical pattern is a spin-off of a controlled subsidiary followed by an initial public offering of the new company's stock. The pre-IPO spin-off has several advantages for corporations and shareholders. The main benefit is a higher stock price from the stock offering. Investors typically prefer to own stock in a parent corporation rather than in a controlled subsidiary.[195] Consequently, it is generally accepted that "an offering of publicly traded stock by a widely-held corporation without significant shareholders will raise more funds per share than an offering by the same corporation in the position of a controlled subsidiary."[196]

In other words, two or more businesses may often be worth more apart than together.[197] For example, when Varian Associates, Inc. ("Varian") announced spin-off plans in August 1998,[198] analysts pre-

192. Stewart, *supra* note 184, at 653.

193. *See* Unger, *supra* note 191, at 394.

194. *See* Lynch, *supra* note 12, at 961 (discussing the consequences of section 355(e) and concluding that "[t]hese provisions in most cases will effectively eliminate Morris Trust transactions").

195. *See* Freeman et al., *supra* note 4, at 1126.

196. *Id.* The IRS will usually concede this point "without extensive substantiation." *Id.*

197. *See* Stephen P. Fattman & Robert A. Rizzi, *Selected Issues in Spin-Offs, Split-Offs, and Split-Ups*, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 1997, at 7, 50 (PLI Tax L. and Prac. Course Handbook Series No. J-409, 1997).

198. The company planned to spin-off its health care unit and instruments operations each into separate companies while keeping its semiconductor unit as its core business. *See* Gene G. Marshall, *Is Varian Far More than its Parts?*, Bus. Wk., Oct. 12, 1998, at 62. As of January 22, 1999 the spin-off was still planned but not yet completed. *See Varian Associates Inc.: Results Won't Change Plan to Split into 3 Companies*, Wall St. J., Jan. 22, 1999, at B5.

dicted that the three new businesses the spin-off would create would have a higher value than the existing entity. As one expert forecasted, "the market is placing a value of $1.1 billion on the stock; we believe Varian's three separate businesses will garner... about $1.5 billion. . . ."[199] Similar predictions have accompanied Ford Motor Co.'s ("Ford") unofficial plan to spin off Visteon Automotive Systems ("Visteon"). Ford began considering a spin-off in mid-1998[200] and is expected to carry it out in 2000.[201] According to Visteon's Chairman, the company will fetch a better price as a separate entity.[202] Ford stock currently sells around ten times its earnings, but the Chairman believes Visteon should be worth about twenty times its earnings.[203]

The advantages of using a spin-off in conjunction with an IPO go beyond higher revenues; there are often unique, intangible benefits as well. For example, on January 27, 1999 Compaq announced plans to spin off AltaVista, each company predicting favorable results from the transaction. In the current market climate, AltaVista believes it will fair better as a separate entity because of "'investors' seemingly insatiable demand for stocks with a '.com suffix.'"[204] AltaVista also predicts it will have greater growth as a separate corporation because it will be able to make deals with other Internet businesses and expand into new Internet markets.[205] Moreover, Compaq believes the spin-off could help its own personal computer sales because a bigger AltaVista can in turn refer more online computer buyers to Compaq's web site.[206] The market responded favorably to the news, as Compaq's stock rose 6% the day it announced the spin-off.[207]

The benefits of spin-offs are not limited to publicly traded corporations. Spin-offs can also help closely held corporations attract investors.[208] For example, suppose a closely held computer software company owns all of the stock of a subsidiary corporation and the

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199. Marshall, *supra* note 198, at 62.

200. *See* John Lippert, *Ford Parts Unit Earnings Are Up*, Pitt. Post-Gazette, May 22, 1998, at E8.

201. *See* Fara Warner & Joseph B. White, *Ford Plans to Reduce Costs by Another $1 Billion*, Wall St. J., Jan. 8, 1999, at A3 ("Ford is expected to wait until 2000 to spin off Visteon, because GM is likely to swallow up interest in auto-parts IPOs with an offering of its huge Delphi parts operation this year."); *see also* Joseph B. White, *GM Files IPO for Delphi Automotive Stake*, Wall St. J., Nov. 17, 1998, at A3 ("Ford has been readying Visteon for an estimated $11 billion IPO, but in October, Ford Chief Financial Officer John Devine said he didn't think there was a market for two such offerings in 1999.").

202. *See* Lippert, *supra* note 200.

203. *See id.*

204. *Mining for Internet Gold Compaq to Spinoff AltaVista as Public Stock Offering*, Tulsa World, Jan. 27, 1999, at 3.

205. *See id.*

206. *See id.*

207. *See id.*

208. This fact pattern is an abbreviated version of the one presented in Rev. Rul. 82-130, 1982-2 C.B. 83.

subsidiary owns and operates residential rental properties. Moreover, the software company is growing rapidly and needs substantial capital to finance its growth. Unfortunately, the parent company's traditional sources of debt financing decline to loan it more money. The parent approaches several securities underwriters to explore equity financing through a public offering of the parent's stock. The underwriters have concerns about the high amount of long-term debt on the consolidated balance sheet attributable to the real estate subsidiary. The underwriters also believe that most investors looking to buy a stake in a software company will be deterred because a significant portion of the value of the parent's stock includes the real estate business of the subsidiary. A spin-off solves the problem. The stock of the subsidiary is distributed to the parent's shareholders, enabling the parent to prepare a balance sheet with substantially smaller debt. The underwriters can now market the parent to software investors without the baggage of the real estate business.

C. *Unlocking Hidden Value*

Spin-offs can also unlock hidden value in existing businesses, thereby creating rewards for shareholders.[209] By separating a controlled subsidiary from its parent, corporate managers can make the new entity more attractive to investors who will then be able to invest in a single line of business without being forced to purchase an entire package. This can be especially effective where the controlling corporation and the subsidiary are in conflicting lines of business and the spin-off separates those businesses.[210] The same principle applies where spin-offs are used to separate businesses with different capital requirements or different operating characteristics; spin-offs allow investors to pinpoint where to place their money.[211] Perhaps the best example of a spin-off unlocking hidden value in this way is AT&T's spin-off of Lucent Technologies ("Lucent"). Lucent's potential had been stifled as an AT&T subsidiary because it occupied a different and conflicting niche than its parent company. The spin-off unleashed Lucent, tripling its stock price[212] and creating a windfall for shareholders.[213]

A similar result occurred when Commercial Intertech ("Intertech") spun off Cuno Inc. ("Cuno") in 1996. The spin-off was initiated with a number of goals in mind. The companies were in different lines of

209. *See* Wander et al., *supra* note 3, at 314.
210. *See id.* at 315-17.
211. *See id.*
212. *See* Lawless, *supra* note 7, at 46.
213. *See AT&T Spinoff Lucent Makes Historic IPO*, L.A. Times, April 4, 1996, at D1 ("The Baby Bell telephone companies, for example, now among Lucent's largest customers, had become reluctant to buy their phone equipment from AT&T as the telephone giant positioned itself as a competitor in the local phone business.")

business and Intertech "believed that the business of Cuno required different management experience and capabilities than Intertech's other businesses, to maximize the growth potential of each business."[214] The spin-off "would allow the management of each company to better recognize and evaluate the different growth characteristics of the two companies."[215] A more specific concern, however, was shareholder value. Cuno had a higher growth rate than many of Intertech's other businesses, but Cuno's value was not properly reflected in Intertech's stock price because the subsidiary's value was shielded by Intertech's core mix of industrial businesses.[216] The spin-off removed this shield and gave investors a better picture of Cuno's real value, resulting in a higher stock price for shareholders.[217]

Traditional cost accounting practices, which frequently understate the value of a result, can also cause problems of subsidiary visibility.[218] Spin-offs can help unlock value in a particular asset or line of business[219] where that business is carried on the books at low value and would trigger a big tax bill if sold.[220] Much like Cuno, if a business remains hidden on a large corporate balance sheet and is barely visible, a spin-off can unveil the asset to potential investors.[221]

D. *Reorganizations that Make Corporations Fit and Focused*

Spin-offs can also be an effective tool in corporate reorganization and increase shareholder value by making a corporation "fit and focussed." The IRS has conceded the importance of corporate fitness by permitting fit and focus to be a valid business purpose when spin-offs are used to "enhance the success of the businesses by enabling the corporations to resolve management, systemic, or other problems that arise (or are exacerbated) by taxpayer's operation of different businesses."[222] Publicly traded corporations must provide the IRS with documentation explaining the nature of the company's problem and how the spin-off will help solve it.[223]

A number of problems may motivate a corporation to improve its fitness via spin-offs. For instance, disagreements among major share-

214. *See* Wander et al., *supra* note 3, at 316.
215. *Id.*
216. *See id.* at 317.
217. On September 9, 1996 Cuno's stock traded at $15.125. *See* Yahoo!Finance (last visited Sept. 3, 1999) <http://chart.yahoo.com/t?a=09&b=09&c=96&d=09&e=09&f=96&g=d&s=cuno&y=0&z=>. On June 9, 1997 the combined price of Commercial Intertech and Cuno was $30 ¼. *See* Wander et al., *supra* note 3, at 318.
218. *See* Steven Lipin & Randall Smith, *Spinoffs Flourish, Fueled by Tax Status, Investor Pressure and Stock Performance*, Wall St. J., June 15, 1997 at C1.
219. *See id.*
220. *See id.*
221. *See id.*
222. Wilson, *supra* note 22, at 110.
223. *See id.*

holders may be resolved by spinning off new businesses so that each significant shareholder can control a separate business.[224] Shareholders may prefer to separate business entities in order to focus their energies on a particular business that best suits their interests and abilities.[225] In addition, spin-offs may enable management to run a company more effectively by focusing efforts on the "core business" of the corporation.[226] Companies experiencing problems with suppliers or customers may find that spin-offs make the company more competitive by streamlining the organization and enabling management to improve relations with customers and suppliers.[227] Finally, conflicting management groups and financial problems within a large corporation can lead to lost synergies;[228] spin-offs isolate problems at their sources and reduce those lost synergies.[229]

DuPont's recently completed partial spin-off of Conoco, which was followed by an IPO of Conoco stock, illustrates how spin-offs can improve fitness and focus. The October 1998 IPO was the largest domestic IPO ever and raised $4.4 billion.[230] DuPont plans to divest itself completely of Conoco stock when the market is right.[231] The move is designed to make both companies more fit and focused.[232] DuPont wants to transform itself into a life sciences company[233] and expand its existing agricultural and pharmaceutical businesses.[234] Be-

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224. *See* Freeman et al., *supra* note 4, at 1136-37.
225. *See id.* at 1138.
226. *See id.* at 1141-42.
227. *See id.* at 1147.
228. *See* Fattman & Rizzi, *supra* note 197, at 42-43.
229. Some analysts explain the gains shareholders realize from spin-offs according to the "Negative Synergies Theory." *See, e.g.*, Buckley, *supra* note 1, at 825-26 ("With positive synergies, an acquisition increases firm value by an amount exceeding the cost of the acquired assets. With negative synergies . . . there is a 'lack of fit' between divisions of the firm, and the divested unit is worth more when separately owned."). Firms that grow too large will experience problems "constrain[ing] opportunistic subordinates" and monitoring divisional performance. *See id.* at 826. By breaking up conglomerates, companies can become more manageable and shareholders can better monitor divisional performance. *See id.*; *see also* R. Hal Mason & Maurice B. Goudzwaard, *Performance of Conglomerate Firms: A Portfolio Approach*, 31 J. Fin. 39, 47 (1976) (comparing a portfolio of conglomerates with a matched portfolio of non-conglomerates and finding that the rate of return to shareholders of non-conglomerates was higher by 6.5%).
230. *See* Dunstan Prial, *Two Scuttled Internet IPOs Overshadow Success of Record-Breaking Conoco Deal*, Wall St. J., Oct. 26, 1998, at B11.
231. *See Dupont Raises $4.2 Billion in Conoco Stock Sale*, Chemical & Engineering News, Nov. 2, 1998, at 12.
232. Dupont's CEO stated, "Conoco has been a strong contributor to Dupont's earnings and cash flow for nearly 17 years. . . . However, we believe that value and growth can be enhanced for Dupont's materials and life sciences businesses and for Conoco by separating the two operations." *Conoco Spin-Off Revives Phillips Merger Hopes*, 21st Century Fuels, June 1998, at 6.
233. *See* Susan Warren, *Dupont to Sell 25% of Conoco to the Public*, Wall St. J., Sept. 29, 1998, at B20.
234. *See DuPont Raises $4.2 Billion in Conoco Stock Sale*, *supra* note 231, at 12.

cause of the spin-off, it now has the capital to do so. For its part, Conoco wants to explore investment opportunities in the energy industry brought about by global privatization and deregulation. Conoco's CEO believes the "IPO will provide Conoco with the means to capitalize on those opportunities."[235]

Similarly, when General Motors ("GM") announced plans to spin off Delphi Automotive Systems ("Delphi") in December 1998,[236] a Delphi spokesperson cited as advantages of the spin-off "greater planning flexibility, the ability to use our stock for acquisitions and the opportunity to form alliances with companies not willing to partner with a supplier owned by GM."[237] In February 1999, Delphi went public at $17 per share, generating $1.7 billion in revenues.[238] GM retained 82% of Delphi's stock after the IPO but will likely use a spin-off to divest itself of the stock later this year.[239] Although Delphi is the largest auto-parts maker in the world, profit performance as a GM subsidiary was disappointing.[240] The company believes that severing its ties to GM will enable it to "cut costs and expand business with other auto makers."[241] Delphi also predicts it will be able to improve the productivity of its workforce and reduce labor costs now that it has direct control over its labor relations.[242]

Ford hopes to follow suit next year with a spin-off of its own auto-parts subsidiary, Visteon.[243] Visteon's president says its goals are very different from those of Ford and "'in the long term, we have to be an independent company' to accomplish them."[244] The company wants to expand its client base beyond Ford customers, who accounted for approximately 90% of its business in 1998,[245] and develop stronger ties with other automakers.[246]

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235. *See Conoco Spin-Off Revives Phillips Merger Hopes*, *supra* note 232, at 6.

236. *See Delphi Expects Offering to Yield $14-$18 a Share; GM Likely to Remain Biggest Customer of Spun-off Company; Auto Parts*, Balt. Sun, Dec. 24, 1998, at 8D.

237. *Id.*

238. *See* Gregory L. White, *GM's Delphi IPO Meets Expectations, Raises $1.7 Billion*, Wall St. J., Feb. 5, 1999, at B4.

239. *See id.*

240. Delphi's net income fell 36% in 1998. *See id.*

241. *Id.*

242. GM's contract with the United Auto Workers governed 29% of Delphi's unionized workers resulting in labor costs considerably higher than the industry average. *See* White, *supra* note 238, at B4.

243. *See* Warner & White, *supra* note 201, at A3 (explaining that Ford is waiting until 2000 because it does not believe the IPO market can accommodate two huge auto-part IPOs in one year).

244. *See Visteon's President Says Independence From Ford is a Goal,* Wall St. J., Jan. 12, 1999, *available in* Westlaw 1999 WL-WSJ 5436370.

245. *See* Lippert, *supra* note 200.

246. *See* Fara Warner, *Ford's Next CEO Brings in New Guard As Seven Veteran Executives Set Exits*, Wall St. J., Oct. 12, 1998, at B5 (discussing Visteon's strategy of making itself more independent from Ford in order to supply more parts to Ford's competitors).

E. *Improving Management Accountability and Efficiency*

A basic problem with the structure of modern corporations is the phenomenon of agency costs.[247] Most large corporations are owned by shareholders but run by managers who typically own little or no equity. The "separation of ownership and control" carries certain costs since managers do not have the same incentives as owners.[248] Whereas owners' primary interest is maximizing firm value, management's "primary stake in the enterprise consist[s] of a set of fixed interests, such as employment, salary, and the enjoyment of certain perquisites of corporate control."[249] Managers' fiduciary duty to their shareholders often proves insufficient to overcome these more self-interested concerns.

Indeed, corporate managers sometimes have incentives to keep large corporate entities together rather than break them up. Larger size may mean higher compensation because firms choose to reward empire building.[250] Size may also give management a sense of job security, as managers are less likely to fear bankruptcy[251] or hostile takeover.[252] In addition, large corporate structures make it easier to hide managerial mistakes.[253] For example, Warren Buffet, believes that "[m]any corporations that consistently show good returns both on equity and on overall incremental capital have . . . employed a large portion of their retained earnings on an economically unattractive, even disastrous, basis. Their marvelous core businesses . . . camouflage repeated failures in capital allocation elsewhere."[254]

Monitoring management is difficult for shareholders generally, but extremely difficult in large, publicly-traded entities where no single individual owns anything close to a controlling interest.[255] Spin-offs

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247. *See generally* Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 69-119 (1932) (discussing the separation of ownership and control in corporations and the resulting changes in the concept of private property).

248. *See id.* at 89.

249. Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 Hous. L. Rev. 399, 400 n.1 (1998).

250. *See* Buckley, *supra* note 1, at 827; *see also* George P. Baker et al., *Compensation and Incentives: Practice v. Theory*, 43 J. Fin. 593, 609-10 (1988) (noting an increase in executive compensation with an increase in firm size). Changes in compensation arrangements can induce management to favor spin-offs. *See* Steven Lipin & Randall Smith, *Spinoffs Flourish Fueled by Taxes, Investor Pressure and Stock Performance*, Wall St. J., June 15, 1995, at C1 ("[C]orporate chieftans are more willing to break up their empires because their compensation is increasingly based on stock-market performance rather than the sheer size of the company.").

251. *See* Buckley, *supra* note 1, at 827-28.

252. *See id.* at 827. This sense of security may be eroding with the recent wave of leveraged buyouts. *See id.* at 809 n.10 (noting that junkbond financing has facilitated takeovers of "even the largest corporate behemoths").

253. *See* Warren E. Buffett, *The Essays of Warren Buffet: Lessons for Corporate America*, 19 Cardozo L. Rev. 1, 126 (1997).

254. *Id.*

255. A shareholder's incentive to monitor management increases in proportion to

are thus a highly effective method of reorganizing corporations to reduce agency costs and better align managerial and shareholder interests. In other words, spin-offs are not only a means of carrying out management's fiduciary duty to maximize shareholder value, but by increasing management accountability, they make it more likely that management will carry out those duties in the future. Recognizing that management may have selfish reasons for keeping large corporate conglomerates intact, institutional investors in the 1990s began using their influence to push for spin-offs.[256] By breaking large corporate entities into smaller parts, spin-offs create a more transparent corporate structure that better enables shareholders and potential investors to assess managerial decisions. To encourage a spin-off, then, "is to push for a corporate structure that presents a lesser likelihood of sub-optimal earnings retention."[257]

Spinning off poorly performing units can also help to make corporations more efficient. During the 1960s and early 1970s, companies acquired new firms in unrelated lines of business on the theory that bigger was better.[258] Conventional wisdom began to change in the mid-1970s. Large companies were found to be inefficient and undervalued, and analysts drew the conclusion that many firms could operate more effectively if split up into smaller parts.[259] In recent years, corporations have discovered that spin-offs can enhance shareholder value by getting rid of an unprofitable business or division that is dragging down the whole company. With limited exceptions, "conglomerates tend to be valued based on their poorest performing units."[260] Spinning off the worst performing units can thus raise the stock price of the parent. Spin-offs of unprofitable entities can also "strengthen a corporation's balance sheet and attract additional debt and equity investment."[261]

Conversely, the parent sometimes harms the performance of a subsidiary, as was the case when a Siemens semiconductor unit lost $722 million in fiscal year 1998.[262] Part of the loss was attributed to a global slump in the industry, but experts also believe the unit's performance was harmed by the conglomerate's structure.[263] As an executive from a

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her stake in the company.

256. *See* William W. Bratton, *Dividends, Noncontractibility, and Corporate Law*, 19 Cardozo L. Rev. 409, 461-63 (1997).

257. *Id.* at 463.

258. *See* Buckley, *supra* note 1, at 808.

259. *See id.*; *see also* Mason & Goudzwaard, *supra* note 233, at 47 (comparing a portfolio of conglomerates with a matched portfolio of non-conglomerates and finding that the non-conglomerates performed about 6.5% better).

260. Wander et al., *supra* note 3, at 314. One notable exception is General Electric. *See id.*

261. Paul, *supra* note 5, at 351.

262. *See* Stephen Baker, *A Case of Too Little, Too Late?*, Bus. Wk., Nov. 16, 1998, at 62.

263. *See id.* at 62-63.

competitor explained, "[t]his industry requires autonomy and extremely fast decision making which is hard when you're part of an industrial conglomerate."[264] Siemens apparently came to the same conclusion and in November 1998 announced plans for a spin-off of the unit.[265]

A more poignant example is the experience of Xerox's Palo Alto Research Center ("PARC") in the 1970s and 1980s. PARC developed a number of important computer technologies including "graphical user interfaces, mice, windows and pull-down menus, laser printing, distributed computing, and Ethernet," but Xerox never put them to effective use.[266] In fact, it didn't bother to patent these inventions.[267] The economic rewards of PARC's innovations ultimately went to new start-up companies like Apple Computer, Inc. and 3Com, each of which operated free of conglomerate constraints.[268] Xerox CEO Paul Allaire confessed that Xerox missed the boat because "[m]anagement was too preoccupied with aggressive competition from Japan in its core copier business."[269] To avoid repeating this mistake, Xerox now follows a strategy of bankrolling entrepreneurial spin-offs of PARC inventions that are not directly related to Xerox's core business.[270]

The experience of U.S. Office Products, which was founded in 1994 as a consolidator of office supply contractors, also demonstrates the limits of conglomeratization. The company rapidly acquired small companies "on the theory that the industry was so fragmented that the small companies it comprised could be acquired cheaply and made more profitable with a dash of organization and management savvy."[271] Despite early successes, U.S. Office Products quickly discovered the limits to its growth strategy. Moving into school supplies and corporate travel services "diluted the company's identity for many analysts and investors."[272] The CEO concluded that the company "had too many moving parts," and, following a spin-off of four operations, asserted that "[w]e feel this restructuring simplifies our story."[273] A Salomon Smith Barney analyst agreed, explaining that "Wall Street loves a pure play, and this plan makes strategic sense because it will clarify U.S. Office Products' core business."[274] The market responded favorably; the

264. *Id.* at 63.
265. *See id.* at 62.
266. *See* Otis Port, *Xerox Won't Duplicate Past Errors: Now, Its Innovations Will Get Used In-house-or Spun Off*, Bus. Wk., Sept. 29, 1997, at 98.
267. *See id.*
268. *See id.*
269. *Id.*
270. *See id.*
271. Jonathan Welsh, *U.S. Office Products Plans to Spin Off Four Operations: Firm to Focus on Core Business in Move Aimed at Simplifying Structure*, Wall St. J., Jan. 14, 1998, at B6.
272. *Id.*
273. *Id.*
274. *Id.*

stock price increased 16% the day of the announcement.[275]

Dun & Bradstreet Corporation ("D&B") recently underwent a double dose of spin-offs reversing an acquisition strategy and creating marvelous gains for shareholders of what had been "a long-time underperform[ing]" stock.[276] In 1996, the company spun itself off into three separate entities—Cognizant Corp. ("Cognizant"), A.C. Nielson, and a slimmed-down D&B—predicting correctly "that the sum of the parts would be worth more than the whole."[277] This first round of spin-offs resulted in a 40% gain for shareholders.[278] In January 1998, plans were announced for round two as both D&B and Cognizant planned further spin-offs.[279] In less than three years, one company was divided into five.

As the previous examples demonstrate, de-conglomeratizing sends positive signals to investors: "the market today takes the position that if the parts of a conglomerate have different investment characteristics, the companies will fail to attract a large investor audience."[280] Investors and analysts therefore "prefer straight forward, simple to analyze, pure-play companies rather than hybrids."[281]

IV. PROPOSALS FOR AMENDING SECTION 355 TO FACILITATE LEGITIMATE SPIN-OFFS

The legal roadblocks to spin-offs set up by the tax code ultimately hurt shareholders—primarily because spin-offs have enormous potential to enhance shareholder value. Studies comparing the stock price the day a spin-off is announced with the price one or two days earlier have found an increase of between 3.3% and 5%.[282] Studies examin-

275. *See id.*
276. Lipin, *supra* note 7.
277. *Id.*
278. *See id.*
279. In December 1997 Dun & Bradstreet announced it would spin off Reuben H. Donnelly Corp. division. *See id.* One month later, Cognizant announced plans to split into two separately traded companies—IMS Health and Nielsen Media Research. *See id.*
280. *See* Wander et al., *supra* note 3, at 314. One notable exception is General Electric. *See id.*
281. *See id.* at 314. Some analysts' forecasts indicate that conglomerates may become a thing of the past altogether. For example, in 1995 Barbara Goldstein of Rothschild Inc. proclaimed that "[t]he age of conglomerates is history." Lipin & Smith, *supra* note 218. She further explained, "[t]hat's good news for investors... because they will be increasingly able to pick and choose what kinds of assets they want to own rather than having to take or leave some assemblage of companies put together by a conglomerate's corporate managers." *Id.* The response of skeptics is to point out that some conglomerates like General Electric still manage to do quite well. *See* Wander et al., *supra* note 3, at 314.
282. *See* Gailen L. Hite & James E. Owers, *Security Price Reactions Around Corporate Spin-off Announcements*, 12 J. Fin. Econ. 409, 421 (1983) (finding a 3.3% increase for a study of 123 spin-offs between 1963 and 1980); *see also* James A. Miles & James D. Rosenfeld, *The Effect of Voluntary Spin-off Announcements on Shareholder*

ing a larger time frame reveal greater returns. One study found a 9.7% increase compared with the stock price ten days prior to the announcement,[283] while a study looking at a fifty-day period found a 7.3% increase.[284] The picture becomes even brighter in the long-term. Spin-offs out-perform the stock market by more than 20% on average during the first eighteen months after the transaction while also increasing the parent company's share price.[285] The parent's stock price is not damaged because declines that accompany the loss of assets to the new spin-off are offset by the gains that accompany the announcement of the spin-off.[286] As a result, "the distribution of subsidiary stock on average results in a pure gain for shareholders."[287] In practical terms, an investor who purchased every spin-off between 1990 and 1997 would have returned "an annualized 31.8%, 18 points better than the S&P 500."[288]

Wealth, 38 J. Fin. 1597, 1601-02 (1983) (finding a 3.3% increase for a study of fifty-five spin-offs between 1962 and 1981). These studies may underestimate the effect of spin-offs. Another study excluded incomplete spin-offs from its sample and found increases of 5%. *See* Thomas E. Copeland et al., *Corporate Spinoffs: Multiple Announcement and Ex-date Abnormal Performance, in* Modern Finance and Industrial Economics 114, 131 (Thomas E. Copeland ed., 1987).

283. *See* James D. Rosenfeld, *Additional Evidence of the Relation Between Divestiture Announcements and Shareholder Wealth*, 39 J. Fin. 1437, 1443 (1984).

284. *See* Hite & Owers, *supra* note 282, at 421.

285. *See* Lipin & Smith, *supra* note 218. *But see* Roger Lowenstein, *Corporate Breakups are No Panacea*, Wall St. J., June 5, 1997, at C1 (quoting an analyst's view that "the notion that companies are instantly worth more by virtue of announcing a spin-off is absurd"); Bridget O'Brian, *Insiders Boost Spinoffs, Buying the Newborn Companies Apace*, Wall St. J., September 24, 1997, at C1 (discussing one analyst's claim that companies spun off before 1995 have a better track record than those spun off after 1995).

286. *See* Buckley, *supra* note 1, at 812 (explaining that the announcement gains offset the average 6.6% decline experienced by the parent because of the loss of the subsidiary's assets).

287. *Id.*

288. John R. Hayes, *Pepsi's Panacea: Wall Street Loves Splitups. But What Does the Record Show About Them?*, Forbes, Oct. 20, 1997, at 215, 215 (quoting Steven Bergman, senior analyst of the Spinoff Report). Yet, in perhaps the greatest corporate law irony of the 1990s, even though spin-offs have produced better results for shareholders, mergers and acquisitions have captured the headlines and set records for pace of activity. *See, e.g.*, Patrick McGeehan, *Salomon Had Credit Dispute for M&A Role*, Wall St. J., Jan. 7, 1999, at A19 (explaining how 1998 was "the biggest year on record in mergers and acquisitions"). Despite the popularity of acquisitions, however, there is no conclusive evidence showing that they enhance shareholder value. On the contrary, several studies have found that conglomerate acquisitions are value decreasing. *See* Lily Kahng, *Resurrecting the* General Utilities *Doctrine*, 39 B.C. L. Rev. 1087, 1108 (1998) ("The value increasing transactions include bust-up acquisitions, leveraged acquisitions, spin-offs and sell-offs in which the proceeds are distributed to shareholders. Value-decreasing transactions include stock-financed acquisitions and sell-offs in which sale proceeds are retained.") The law has failed to come to terms with this evidence. Indeed, current corporate law seems oblivious to it. As it stands, American corporate law is generally acquisition friendly but divestiture unfriendly: "most corporate statutes impede the sale, but not the purchase, of a division," stipulating that a "purchase of new assets does not require shareholder ap-

Despite these obvious benefits, however, Congress and the IRS have adopted hostile stances toward spin-offs. Although Congress does have a responsibility to look out for the well being of the U.S. Treasury, it has allowed a small number of high profile, tax-free spin-offs to catch its attention.[289] Prudent corporate tax policy, however, involves balancing fiscal responsibility with the economic needs of corporations and their shareholders. It also should not frustrate other areas of the law integral to the corporate enterprise. The anti-spin-off components of the Taxpayer Relief Act of 1997 are bad tax policy because they overlook the economic efficiency of spin-off transactions and therefore impede management's ability to carry out its fiduciary duty to maximize shareholder value.[290] As discussed above, spin-offs are an effective means of accomplishing a corporate restructuring while enhancing shareholder value.[291] They have also proven to help corporations cut costs, streamline business, raise revenue, attract investors, improve management, and improve stock prices.[292] Spin-offs contribute to corporate well being, and a healthy corporate America in turn translates into higher profits and ultimately higher tax revenues for the federal government. To remain competitive in a rapidly changing global marketplace, corporations need to have effective restructuring weapons at their disposal.[293]

Perhaps the most disappointing aspect of the anti-spin-off tax reforms is that Congress could have achieved its goal of preventing tax avoidance and abuse without curtailing legitimate spin-offs. Congress was concerned about deals which took the form of spin-offs but which were, in essence, sales of assets.[294] Congress reacted to deals that were

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proval, but a sale of all or substantially all of the firm's assets" requires shareholder consent. *See* Buckley, *supra* note 1, at 806. Congress and the IRS have reinforced this anti-divestiture bias encoded in state corporate statutes by adopting a hostile stance toward spin-offs.

289. *See supra* notes 188-89 and accompanying text.

290. *See* Stewart, *supra* note 184, at 653.

291. *See supra* Part III.C-D.

292. *See supra* Part III.B.

293. *See* Unger, *supra* note 191, at 695. In addition to the burdens of section 355(e), the Treasury Department is proposing further limits on spin-offs. *See* Anita Raghavan, *Treasury's Latest Plan Against Shelters for Corporate Taxes Worries Wall Street*, Wall St. J., Feb. 3, 1999, at C11. Ironically, just as the federal government is making spin-offs more difficult at home, European companies are discovering their value. After years of conglomeratization, Europe's biggest technology giants are using spin-offs to improve the bottom line. *See* Baker, *supra* note 262, at 62. Despite first-rate technology, Germany's Siemens, France's Alcatel, and Holland's Royal Philips watched their stocks take a beating in 1998 as "investors worried about their ability to keep up with the speed of innovation." *Id.* All three companies responded with spin-offs designed to streamline their businesses, cut costs, regain investor confidence, and shore up their stock prices. *See id.* at 62-63. Siemens spun off its semiconducter and components businesses, Phillips got rid of Polygram, and Alacatel spun off its engineering unit. *See id.*

294. *See supra* notes 188-89 and accompanying text; *see also* Unger, *supra* note 191, at 695.

all highly leveraged.[295] In these transactions, the business which was spun off borrowed large amounts of cash and transferred that cash to the parent.[296] Congress correctly perceived that these deals were economically similar to sales of the spun off entity by the parent in exchange for cash.[297] Congress went astray in drafting legislation that assumes all spin-offs are truly sales when in fact only a small number of highly leveraged deals meet this criteria.

The tax committee of the New York City Bar Association provided Congress with a simple solution to the problem. The Committee's recommendation was a formula for taxing spin-offs based on a comparison of the debt-to-value ratio of the parent and the spin-off.[298] The proposal set the level of gain recognition based on the amount by which the debt-to-value ratio of the new entity exceeded the debt-to-value ratio of the pre-spin-off parent.[299] Any *Morris Trust* transaction in which the new entity was more leveraged than the pre-spin-off entity would thus be taxed as a sale in proportion to the discrepancy.[300] This proposal would have closed the loophole that troubled Congress without imposing burdens on spin-offs motivated by non-tax concerns. Unfortunately, Congress ignored the Committee's advice. While it is not too late to adopt this solution, Congress and the Treasury Department have shown no such inclination.[301]

Some scholars have called for the repeal of section 355(e), arguing that the statute "misconceives the principle underlying the repeal of *General Utilities* and imposes corporate tax liability where there is no corresponding step-up in basis."[302] The tax section of the American Bar Association ("ABA") has, less drastically, argued for the reform of section 355(e). In its letter to the IRS addressing section 355(e) issues, the ABA tax section expressed concern that the lack of safe-harbor provisions would "unreasonably chill" the use of section 355 or, on the flip side, the acquisition of a distributing or controlled corporation after a spin-off.[303] The ABA argued that the current statutory scheme has the effect of a "poison pill" on acquisitions involving either the distributing or controlled corporation within two years of a spin-off.[304] According to the ABA, a distributing corporation espouses a de facto "poison pill" because it must recognize a gain when-

295. *See supra* notes 184-92 and accompanying text.
296. *See supra* notes 184-92 and accompanying text.
297. *See supra* notes 184-92 and accompanying text.
298. *See* Unger, *supra* note 191, at 695.
299. *See id.*
300. *See id.*
301. On the contrary, the Treasury Department has proposed additional anti-spin-off regulations. *See* Raghavan, *supra* note 293.
302. Wolfman, *supra* note 66, at 329.
303. *See ABA Members Request Guidance on New Corporate Reorganization Provisions*, Tax Notes Today, May 14, 1998 *available in* LEXIS, FedTax Library, TNT File.
304. *See id.*

ever there is a greater than 50% change in ownership involving the distributing or the controlled corporation following a spin-off.[305] With respect to controlled corporations, however, the target would possess a "poison pill" only if the target is a controlled corporation that is obligated to indemnify its distributing parent from a tax liability caused by a change of ownership.[306]

In its letter to the IRS, the ABA made numerous recommendations for reforming section 355(e). For example, the ABA has recommended that the definition of a "plan" should encompass the intent of a party only when that party has the power to effect the series of related transactions.[307] A "plan" would thus hold the same meaning as the traditional step transaction doctrine.[308] The ABA also suggested that where there is a distribution involving more than one controlled corporation and section 355(e) subsequently becomes applicable, gain recognition should be limited to the stock of the controlled corporation whose ownership has changed.[309] This modification would ensure that the change of ownership of one controlled corporation would not trigger gain recognition with respect to the stock of all distributed controlled corporations, or worse yet, the stock of any controlled corporation, distributed or undistributed, whose stock has appreciated.[310]

Finally, it may be wise for Congress to revise the measure of tax for section 355(e) transactions. Presently, Congress has chosen to measure the tax based on the appreciation of the stock of the spun-off subsidiary regardless of which entity in the group is disposed of in the end.[311] Indeed, when the subsequent disposition involves the spun-off subsidiary, the justification for measuring the tax based on the built-in gain in the stock of that particular subsidiary is self-evident. If the disposition involves the distributing corporation, however, the measure of tax should be the value of the distributing corporation, not that

305. *See id.*
306. *See id.*
307. *See id.*
308. *See id.* With respect to section 351 of the Code, for example, the step-transaction doctrine is implicated whenever there is a sale of stock by members of the control group immediately after an exchange, which results in the loss of control because the buyers are unrelated to the corporation and do not become part of the control group as a result of the purchase. *See* Bittker & Eustice, *supra* note 16, ¶ 3.09[3]. To be included in the control group, "each transferor must transfer property, receive only stock in the exchange... own such stock 'immediately after' the exchange all as part of an integrated transaction between the corporation and the other transferors." *Id.* ¶ 3.08[1].
309. *See ABA Members Request Guidance on New Corporate Reorganization Provisions*, *supra* note 303. This recommendation is aimed at clarifying the phrase "any controlled corporation" included in section 355(e)(1). *See id.*
310. *See id.*
311. *See, e.g.*, Yin, *supra* note 52, at 376; *see also* Michael Schler, *The Section 355(e) Debate, Round 4*, Tax Notes, Aug. 24, 1998, at 971, 971-72 (arguing that Professor Yin's proposal to revise section 355(e) is unnecessary).

of the spun-off subsidiary.[312]

Since the historic shareholders continue to own the stock of the subsidiary, there is continuity of interest and, therefore, logic precludes the imposition of a tax based on the built-in gain of the subsidiary stock.[313] Congress may have chosen to measure the tax this way to ease administrative burdens.[314] Nevertheless, Congress may be forced to re-evaluate its position, because where there is a significant difference in the amount of built-in gain between the distributing and controlled corporation stock, the current tax scheme encourages creative tax planning strategies that aim to minimize the overall tax burden of the distributing group.[315]

CONCLUSION

Corporate directors and officers have a fiduciary duty to maximize shareholder value, and in many cases spin-offs have proven to be an effective means of doing so. Yet, Congress and the IRS have focused obsessively on the tax avoidance possibilities inherent in section 355 transactions. As a result, the tax code and surrounding Treasury regulations and rulings overly constrain management's ability to carry out legitimate, non-tax motivated spin-offs. Such impediments are not only poor tax and economic policy, they are also unnecessary. Other legal safeguards against improper spin-offs, such as shareholder suits and state fraudulent conveyance laws, suffice to restrain management from effecting spin-offs to entrench themselves or to avoid massive tort liability.

The tax laws should not impede directors' and officers' abilities to carry out their legally mandated fiduciary duties to their shareholders; nor, in the case of spin-offs, need they. Tax is a blunt and convoluted instrument for the type of change Congress desires. This type of tax based regulation is inefficient and causes economic distortions. Reasonable proposals to revise the tax code, and especially section 355(e), if adopted, would preserve protections against spin-offs effected for tax avoidance, while facilitating legitimate, non-tax motivated spin-offs. The corporate and tax bars should seriously consider these proposals and work toward their adoption.

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312. *See* Schler, *supra* note 311, at 971-72.
313. *See id.*
314. *See* Yin, *supra* note 52, at 376.
315. *See id.*

Notes & Observations